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A NATIONAL JOURNAL OF CURRENT NEWS & COMMENT FOR PROFESSIONAL TAX MEN

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Tax problems of the buyer of a going corporate business under the 1954 Code

by JACKSON L. BOUGHNER

Use of the corporate form is the only way to achieve certain tax advantages in the purchase of a going business. This usually comes down to getting either high basis (with a profitable business) or a good loss carryover (with a nonprofitable business). The new tax law has changed many of the tax considerations which bear on such an acquisition. The article which follows is concerned with the general tactical and legal problems, through which discussion are woven the applicable tax considerations

A GREAT DEAL has been written on sales of going businesses from the standpoint of the seller, to whom it is usually a one-shot proposition. But the buyer's problems are often more difficult than the seller's. It is the buyer who will henceforth operate the business and who must bear the burden of any errors made in the manner of acquisition.

The buyer has actually only two tax problems of his own to consider. One is the basis of the property acquired, and the other the right to enjoy the tax benefits the business has in the hands of the seller. Often, however, the transaction is consummated in a form dictated by the seller's tax problems. The buyer must take it as it is offered him, and work out his own solution to his tax problems, without any cooperation from the seller whatever.

Going businesses may, for purposes of this discussion, be divided into two types, the successful and the unsuccessful. When a corporation purchases a successful going business, it is generally most interested in seeing that it obtains, for depreciation and accounting purposes, full value for what it has paid. When it acquires an unsuccessful business, preservation of a net operating loss carryover, or of a large invested capital credit for excess profits tax purposes, are paramount. In other words, basis problems are most important when we acquire the successful business, and carryover problems the most important when we are acquiring a losing business. We will first consider the methods of acquiring the profitable enterprise. We will assume that the enterprise is being conducted in the corporate form. The purchase of a sole proprietorship or partnership cannot be done in a tax-free manner, and the problems involved are principally of the seller.

I.—ACQUISITION OF THE SUCCESSFUL CORPORATION

The simplest transaction, from the standpoint of the buyer, is the purchase of the business assets of the seller for cash, which may or may not involve a mortgage for part of the purchase price. Purchase of assets enables the buyer to avoid taking those unwanted assets which may cause both tax and valuation problems. Thus, he doesn't have to take the seller's investments which have a market value in excess of cost. If he does take them, the buyer will want to give consideration to the hidden liability—capital gains tax on ultimate disposition. He can let the seller collect his own receivables. These often present difficult valuation problems, and, in addition, there may be undisclosed offsets arising from transactions as to which only the seller can provide the necessary rebutting testimony. The seller may be able to keep his factory building. And, best of all, the buyer doesn't have to worry about the seller's liabilities, disclosed or undisclosed.

Under Section 337 of the Code, a corporation can

sell its assets at a profit, and if it has adopted a plan of liquidation, and liquidates within one year thereafter, there will be no corporate tax on the gain. This provision has tremendously simplified acquisitions of corporate businesses, which, prior to its enactment, had to be done through a purchase of stock, followed by liquidation. It has eliminated the double tax to the seller, as well as certain basis and reorganization problems of the buyer. It solves the problem of the objecting minority stockholder, since the buyer's dealings are with the corporation alone.

The mechanics of this type of purchase are simple. The selling corporation adopts a resolution to dissolve. The lawyers draft a bill of sale and the necessary notices and affidavits to comply with the bulk sales law. The accountants and company officials take a complete inventory of the assets to be transferred, which is attached as an exhibit to the bill of sale. The purchasing corporation can take title in its own name or in that of a subsidiary formed just prior to the purchase. When the buyer is not qualified to do business in the state where the business has been conducted, a wholly-owned domestic subsidiary to take title will solve many problems. The purchase price can be allocated to those items which will help the buyer to the maximum write-off, without in any way harming the seller.

In some cases, the sale will produce little or no gain to the selling corporation, but if it is followed by liquidation, will produce a large capital gain to the stockholders. Under such circumstances it may be desirable for the seller to continue in existence as an investment company. Frequently such corporations pay more to the shareholders as dividends earned on the investment on the total proceeds than the shareholders could realize by investing those proceeds less their capital gains tax.

Cash for stock

In spite of the advantages of a purchase of assets under Section 337, many sellers still refuse to do anything but sell their stock. In some cases this is the result of unfamiliarity with the new provisions and the feeling that until they have been thoroughly tested in the courts, they should not be relied on. In some cases it is the result of laziness on the part of the seller: he doesn't want to wind up his corporation himself. Sometimes his advisors are unsure of their ground. Sometimes there are substantial minority stockholders who have not been active in the affairs of the business and insist on a clean break. At any rate, the buyer is often given the choice of a purchase of stock or no deal at all. If he wants it badly enough, he will accede to the seller's terms.

This type of transaction creates many tax and business problems, which must be carefully considered by the buyer. In many cases, the sellers will actually obstruct the solution of these problems. Thus, the buyer should have a complete audit made by his own auditor, preferably before the selling price is agreed upon. If the buyer is a competitor, however, the seller may well refuse to permit such an audit until he has a firm offer in hand. The buyer may have to take assets he definitely doesn't want, without being permitted to investigate their worth. Thus, he might want to examine the notes and accounts receivable, but is not permitted to do so by the seller.

The biggest stumbling block in this type of transaction is contingent and undisclosed liabilities. Perhaps the business had not been paying sufficient dividends; very likely it has been charging as much to expense as possible; these suggest tax liabilities; quite likely it has various unwritten commitments and agreements that will not come to light until after the sale has taken place. There is usually a reluctance on the part of the seller to afford the buyer the full protection he is entitled to against these contingencies.

The best protection is to place an adequate part of the purchase price in escrow for a sufficient period to permit all such liabilities to be revealed. Many sellers will refuse to enter into such an agreement. Even if they are agreeable, a dispute will arise as to the amount of the escrow and the time limit on its retention. Such an agreement should provide that when a contingent liability has ripened into certainty, it should be treated as a reduction of the purchase price. If the escrow is used to pay the liability directly, the amount thereof will be additional income to the corporation sold.

Sometimes the seller will agree to a reduction in the purchase price to take into account these contingent liabilities. Quite often, however, it will be simply a take it or leave it proposition. Under such circumstances, the buyer will want an indemnity agreement against such liabilities. A substantial minority stockholder, who has not taken part in the affairs of the corporation, may balk at this, or he may insist that he be liable for only his share. In one case I handled recently, our indemnity agreement was of this type, and since one of the stockholders was the estate of a non-resident alien, I have often wondered whether we got any protection at all.

Don't rely on a certification that the balance sheet is true and correct. In a case I handled about two years ago, the buyer made his own examination of the balance sheet and minute book, and was satisfied that all of the liabilities were stated. He wasn't told that six of them had been reduced to judgment. The day after he bought, the sheriff closed the place down. Always get an affidavit as to suits, judgments, bankruptcies, etc.

Sometimes it is intended that the buyer will place a mortgage on the assets to raise part of the purchase price. If this is to be done after the stock has been purchased and the corporation dissolved, raising funds

for the down payment may be difficult. If the seller will accept a note, secured by the stock, with the understanding that it will be paid out of the proceeds of the mortgage, what security has he after the corporation is dissolved and title to its assets has vested in the purchaser? And what if, after dissolving the corporation, the buyer finds either that he can't get a mortgage or that title is no good?

Where these problems are present, it is best if the selling corporation puts the mortgage on before the sale of the stock and has the cash in its till on dissolution. One of the sellers may remain as required co-signer of all checks until the dissolution is complete and the mortgage proceeds have been returned to the sellers.

If the corporation's basis for its assets is greater than the buyer's cost of the stock or if there are other tax benefits in keeping it alive, it can be maintained as a wholly-owned subsidiary until two years have elapsed, when it can be dissolved. Under Section 332 this would be a tax-free liquidation of a subsidiary. The subsidiary's basis will be taken over by the parent, along with any other tax benefits which may be preserved by Section 381. On the other hand when the corporation's basis for its assets is less than the purchase price, the corporation should be dissolved within two years of the purchase. Under Section 334 (b), the basis of the assets acquired will be the same as the cost of the stock. This stepped-up basis can be attained only by the controlling corporation. If you want to operate the business through a subsidiary, it would be best to have the initial purchase made by a subsidiary.

Often we are unable to acquire one hundred per cent of the stock, but want the deal so much that we are willing to take ninety-eight per cent. The two per cent remaining can be very obnoxious. The general rule of corporate law that you cannot dissolve a corporation in such a way that the majority will get the assets and the minority only cash is limiting indeed. One solution is to sell the assets to a subsidiary corporation before dissolution, which leaves the minority with only the right to go into court and have its stock appraised. If it is possible to give the minority an undivided interest, such as in the case of real-estate corporations, they can be given sixty days after the dissolution to elect to take cash or assets, and on failure to elect must accept cash.

Creeping purchases of stock

In some cases, the buyer will acquire a substantial minority interest in another corporation, and later have the opportunity to acquire the balance. This is called creeping control and presents problems that are avoided by an acquisition of all of the stock at once. Under such circumstances, if the cost is greater than the basis of the assets in the hands of the seller, the buyer cannot rely on Section 334 (b) to give him a stepped-up basis. If he does not want a stepped-up basis, he can either continue the old corporation or dissolve it under Section 332 covering tax-free liquidations of subsidiaries. But if he wants the stepped-up basis, he must dissolve in a taxable transaction, making sure that Section 332 is not applicable.

There are two ways of avoiding the application of Section 332. One is to avoid adopting any plan of liquidation, and drag the liquidation out over a period in excess of three years so that the Commissioner can't say there was an informal plan of liquidation. The other is to make sure you don't have 80% of the stock on dissolution. There is nothing in Section 332 making applicable the provisions of Section 318, relating to constructive ownership. Twenty-five per cent of the stock can be taken in the name of a related corporation or individual, who will receive, by tacit agreement, only cash for his interest on dissolution. Here again, if you want to operate through a subsidiary, the subsidiary should own the stock on dissolution.

Assets for stock

In many cases, the seller will want to take stock of the buyer rather than cash, so as to defer his capital gain. Large, publicly-held corporations will often insist on paying with their own stock if they do not wish to impair their working capital. If the stock is listed, it is often the equivalent of cash, and the buyer can pick his own time to dispose of it if he wishes to shift to another investment.

If stock is to be the medium of payment, the best type of transaction is for the selling corporation to transfer to the buyer or its subsidiary the assets that are wanted. Such a transaction is tax-free to the buyer as a "C" type reorganization under Section 368 (a) (1) (C). The mechanics are the same as an acquisition of assets for cash, described above, except that the buyer must take "substantially all" of the assets of the seller. Either the buyer itself, or a subsidiary formed for the purpose, can take title. There is nothing to prevent the seller's shareholders, prior to the sale, from taking out, by purchase, the assets the buyer doesn't want. The buyer need assume no liabilities of the seller, and it is best if he doesn't. Under the 1954 Code, the fact that title is taken in a subsidiary, but stock of the parent is given the seller, does not destroy the tax-free aspects of the transaction to the seller.

The buyer, in such a transaction, will not get a stepped-up basis for the assets acquired: he must use the seller's basis. On the other hand, the buyer can step into the shoes of the seller with reference to the various tax carryover rights allowed under Section 381. If the selling corporation has a net loss carryover, the sellers must acquire at least 20% of the outstanding stock of the buyer if the buyer wishes the full benefit of this deduction. The amount allowable is proportionately reduced as the seller's interest in the buying

corporation diminishes; thus, if the sellers get only ten per cent of the stock, the buyer can deduct only fifty per cent of the loss carryover.

For the reasons set forth above in connection with the purchase of assets for cash, a purchase of assets for stock is the most satisfactory method so far as the buyer is concerned if the transaction is to be tax-free to the seller. The selling corporation will distribute the stock to its stockholders, who will ascribe to it the same basis as that of the stock of the selling corporation in their hands. The seller should pay off its liabilities before the sale and retain only sufficient cash to take care of its contingent liabilities. The buyer acquires none of the seller's liabilities; it can take title in itself or in a subsidiary; and it gets all the tax carryover benefits available to the selling corporation, with the exception of the full net operating loss if the seller gets less than 20 per cent of the buyer's outstanding stock.

Stock for stock

In some cases, the buyer will insist that the transaction take the form of an exchange of stock, and will not agree to a transfer of corporate assets for stock. Such a transaction will be tax-free under Section 368(a)(1)(B) and is commonly called a "B" reorganization. The buyer must acquire control to render it tax-free, but under the statute, the buyer can have been the owner of some of the stock prior to the final transaction. Under a "B" reorganization, unlike the "C" type, the stock involved must be that of the acquiring corporation, not of a parent of the acquiring corporation.

If you wish to keep the business so acquired as a subsidiary, no problem is involved, but if you wish to have both a subsidiary and the stepped-up basis, it is not easy. Any attempt to transfer the assets to another wholly-owned subsidiary will be a tax-free reorganization with no change in basis. Here again, you must dissolve in a taxable transaction, avoiding the application of Section 332 as described above.

This type of transaction has all the disadvantages of a purchase of stock for cash as described before. You take all the assets and liabilities of the seller's corporation, with the added disadvantage that liquidation will not result in a stepped-up basis. It is, of course, tax-free to the buyer, who can hold your stock until his death, if he wishes, and avoid income tax entirely.

Creeping exchange of stock

Just as we can buy the stock of another corporation in a series of transactions, we can also acquire it in exchange for our own stock in a series of transactions. Since the various exchanges will be taxable until the buyer acquires 80%, it is more likely that the stock will be purchased with cash over a period of time, with the final acquisition of control being accomplished by an exchange. This presents no problems different from those involved in a single exchange for over 80% of the stock, unless the final exchange takes place at the same time as a cash purchase. If the two are part of the same transaction, control will not have been acquired "solely" for voting stock, and the transaction will not be tax-free. The seller will have to pay a tax, but the buyer will not be able to get the advantage of a stepped-up basis by liquidation within two years under Section 334(b). The solution is to separate the cash transaction from the stock trade in such a way that they are not part of the same transaction. There should be neither a written nor oral agreement, at the time any part of the stock is purchased, that the rest can be obtained by an ex-

INFLATION IS THE UNLEVIED TAX

IN ANY DISCUSSION of tax reduction it becomes most important to define what is a tax. I suggest, and many economists agree, that inflation is in essence a form of taxation that just as surely takes purchasing power out of the pockets of the private individual and puts it into the hands of the Federal Government as any of the classic forms of taxation. If this is so, and I believe it is so, I think we should consider in this question of tax reduction whether or not the tax of inflation might be reduced.

Certainly those who bore the brunt of it the most are still bearing it. They are those who were retired or are retiring on fixed incomes which, at the time they planned their retirement, did so in terms of twice the 1956 dollar's purchasing power. They have lost and never regained that purchasing power.

If there is a difference between tax take and expenditures on the plus side, an application of this surplus to pay off on the Federal debt would provide the force which would enable additional purchasing power to go back into the dollar and at the same time would produce a better ratio of Federal debt to gross national product.

Those who want to help the little person will do it more by this method of tax reduction than in reducing the personal income tax rates or increasing personal income tax exemptions or in applying the tax reduction to a selected group of specific inequities or economic blocs. After all, there are millions of Americans who don't make enough to pay any income tax; this group is composed largely of widows with minor children, old persons on retirement, disabled persons on pensions or unemployed; and yet they, along with everyone else, as consumers pay the tax of inflation. The fairest, broadest, and most equitable tax reduction is putting purchasing power back into the dollar and cutting this dangerous and insidious tax of inflation. . . . *Congressman Thomas B. Curtis (R-Mo.), speaking at the National Industrial Conference Board's meeting in New York in January on "Should Taxes be Reduced in 1956."*

change.

A statutory merger or consolidation is a tax-free reorganization under Section 368(1)(a)(A). It is generally called an "A" type reorganization. It has exactly the same economic effects as a "C" type reorganization, in which the selling corporation transfers its assets to the buying corporation in exchange for stock of the buying corporation which it then distributes.

The principal tax advantage of an "A" type reorganization over the "C" is that it is not necessary to issue voting stock to the stockholders of the selling corporation. If the two corporations are incorporated in the same state, it simplifies the transaction immensely, since no instruments of transfer are necessary. When the articles of merger or consolidation are filed, the property of the selling corporation is deemed owned by the buyer.

If the two corporations are incorporated in different states, a "C" type reorganization is to be preferred. You have to qualify the buying corporation in the state of the seller. Note that the effective date of a merger or a consolidation is the date the articles are filed with the Secretary of State. Often it is difficult to be sure of the right closing date for such a transaction. In a "C" reorganization, however, the effective date is when the assets are transferred, which can be controlled by dating the papers all as of the same day.

Hybrid transactions

We have discussed, so far, the most common methods of acquiring a going business. However, no two acquisitions are the same, and in many cases, owing to individual idiosyncrasies, we cannot follow the best route.

In some situations, a corporation transferring its assets to another will require cash in addition to voting stock. This happens most often when there is preferred stock to be redeemed. Under such circumstances we must rely on Section 368(a)(2)(B), which permits such a transaction to be tax-free if the cash and liabilities assumed are less than 20% of the fair market value of the property transferred. This can be a trap for the unwary, since contingent and undisclosed liabilities, arising after the transaction is consummated, may upset the best laid plan. When in doubt, use a statutory merger.

We may wish to use stock of both the parent and subsidiary in exchange for the assets of another corporation under a "C" type reorganization. The law does not specifically permit this. Some tax men feel if 80% of the consideration is stock of the subsidiary and 20% that of the parent, the transaction can be effected. Until there have been cases on the subject, we cannot be sure.

As pointed out above, a transaction which involves both cash and voting stock for voting stock will not qualify as a "B" reorganization. However, the Treasury has recently ruled in the *Humble Oil & Refining Company-Standard Oil Co.* case that this rule does not apply to a fractional share brought up to a full share with a small cash payment.

As a general rule, if you vary from a strict stock-for-assets or stock-for-stock transaction, you run the risk that it will not be tax-free. If such a transaction is necessary, it must be considered from every angle.

II.—ACQUISITION OF THE UNSUCCESSFUL CORPORATION

Contrary to popular belief, all losing corporations are not acquired just for the net operating loss carryover. Often the business is one which can be operated at a profit when combined with a full line of products in the same field. Sometimes all that is lacking is adequate working capital or management.

The buyer of a losing corporation will usually want the benefit of the net operating loss carryovers. In addition, such corporations usually have a large debt in the form of notes due the stockholders. These notes will be acquired with the stock and are a method of getting funds out of the corporation, without tax, or, at the least, with only a capital gains tax. Under Section 1232, the excess of the proceeds of a corporate note over its cost to the buyer is now treated as a capital gain, whether or not the notes are registered or coupon-bearing.

The methods of acquiring control of a losing corporation are the same as those described above for acquiring a profitable corporation. We are usually not concerned, however, with basis problems so much as we are with the right to the carryovers. Obviously, therefore, we would not purchase the assets for cash, since this would destroy all of these benefits.

Purchase of stock for cash

The simplest method is to buy the stock for cash and keep the corporation in existence. This method will work perfectly so long as the buyer does not change its business. If it is a company which will continue the same line, at the same place, the only change being new capital or new management, this method should be used. Of course, the buyer cannot immediately start applying the carryover against his own profits. He must wait until after the close of the taxable year following that in which he acquired it before he can work a tax-free dissolution and keep the carryover. Thus, assuming the losing corporation is on the calendar year basis, if it is acquired at any time during 1956, whether in January or December, the buyer must wait until January 1958 to dissolve.

Often the losing corporation is completely out of business, or is in a business which the buyer does not intend to continue to the extent that it will qualify as not having changed its business. This, of course, comes close to the situation of acquiring a corporation for its

net operating loss carryover alone. Where, however, the losing corporation has the plant and equipment for a much larger and more profitable operation, and the buyer acquired it principally for that reason, it runs an almost certain risk of losing the carryovers if a new line is added to the previous one.

Reorganization

The buyer may decide to pursue a safer route, and acquire the stock of the company in a tax-free transaction, either as an "A", "B", or "C" reorganization. In other words, the buyer may merge with the loss corporation, it may exchange its stock for that of the loss corporation, or it may exchange its stock for the assets of the loss corporation. Under any one of these, the buyer will be entitled to the entire loss carryover, if the stockholders of the loss corporation receive at least 20 per cent of the stock of the surviving corporation.

This sounds very simple on the face of it: if we are not going to change the business, buy; if we are going to change it, merge. Many sellers, however, want cash, not stock, particularly if the buying corporation is closely-held. And many buyers don't want a 20 per cent minority. Often both buyer and seller want to be sure that this "tax-inspired marriage" can be safely dissolved at the option of either.

If, at the time of the merger, a firm contract is entered into, under which either party can force a sale of the 20 per cent interest at its own option, the Commissioner would probably say that a sale of stock, not a merger, was what had taken place. How can we arrange for a divorce, and still keep our carryover?

One method that has been suggested is for the buying corporation to continue certain of the seller's officers on its payroll, under an employment contract. At such time as the seller's officers quit or are fired, the contract gives them the right to insist that the buying corporation redeem their stock. In many acquisitions of this type, the buyers want the services of the sellers for the first year or so, until they are thoroughly familiar with the business and its customers. In other words, this is not the type of contract that would necessarily be entered into solely for tax purposes; in many cases, the buyers would insist on the employment part and the sellers on the stock purchase part.

Note further that it is a unilateral agreement; the sale of the stock will take place only at the seller's option. It works fine from the sellers' standpoint: they know that whenever they want to quit their jobs, they can sell their stock. But from the buyer's standpoint, it is not so strong; the sellers can quit and not sell their stock. They might prefer the 20 per cent interest. So we can put a clause in that when they do quit, they must sell. That comes very close to a binding agreement of sale, deferred only while the sellers perform a year or two of services, and whether it would hold up, I do not predict. All I can say is that it is the best suggestion I have seen yet to solve this problem.

Acquisitions to evade taxes

In any acquisition of a corporate business we must consider whether Section 269, relating to acquisitions to evade taxes, may be applicable. Under Section 269(a), if the principal purpose is to acquire a tax benefit, the acquiring corporation will be denied the benefit. This statute has been on the books since World War II, and has had practically no effect whatever. Almost every transaction can have some business purpose attributed to it.

Section 269(b) sets up a presumption of an acquisition to evade taxes if the purchase price is substantially disproportionate to the basis of the property acquired. The Congressional history of this section indicates that it was intended to apply to cases where high-basis assets were acquired for a relatively small amount. The section has not been tested in the court, and most knowledgeable tax men feel that it will be applied only to to flagrant situations of the type described in the Congressional committee reports.

Section 1551 denies the surtax exemptions to any corporation formed for the principal purpose of acquiring such an exemption. If an existing corporation splits in two just to get the extra exemption, the statute would be applicable. Every spin-off comes technically within the provisions of this section. It is of interest that when the Commissioner approves a spin-off in a ruling letter, he specifically reserves judgment as to the applicability of Section 1551. But where a corporation acquires a separate business formerly operated as a corporation, it is extremely doubtful that the section would be applicable, even though the buyer had to first take the assets into the parent corporation and then form a subsidiary.

It should be apparent, from the buyer's standpoint, that either cash or stock for assets is the best form for the transaction. If he wants a stepped-up basis, use cash. If the seller insists, in order to make it tax-free, or if the buyer wants the carryovers, use stock. Acquisition of the seller's stock, using either cash or the buyer's stock, presents tax and business problems and makes for a much more complicated transaction. Creeping control situations must be handled very carefully, principally from the seller's standpoint. In acquiring a losing corporation, use cash for stock unless the buyer is going to change the business, in which case you should arrange for a merger, out of which the sellers get 20% of the stock of the continuing corporation. ☆

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Tax opportunities for U. S. business abroad: a country-by-country analysis of tax rates & laws

by WALTER H. DIAMOND

Planning to take tax advantage of doing business abroad requires thinking in specific terms—tax rates and related laws and regulations applicable in each of the foreign countries one desires to consider. This article is intended as a guide for such thinking; it sets forth briefly the essence of foreign taxation of U. S. business, to enable the reader to compare easily the advantages and disadvantages of each country. It is a convenient prelude to the final exhaustive study of a particular country's tax system

OF THE ESTIMATED 300 U. S. companies which made investments in new overseas plants in the past year, over 150 were in the countries where a program of tax incentives to induce foreign capital has been recently initiated. The majority of foreign government measures are designed to lure manufacturing industries. Almost all the tax inducements apply only to those new industries "fundamental to the economy." This is why manufacturing investments of U. S. companies placed overseas have jumped nearly 40% in recent years. Today, over $7.5 billion of the total $18.5 billion in direct foreign capital invested by American firms is in manufacturing operations.

Two important events since 1955 have contributed considerably to the decisions by many countries to take steps attracting U. S. capital. First, as a result of the Inter-American Economic Conference held in Brazil in November 1955, the Eisenhower administration is committed to the 14% tax reduction on income earned from abroad. Second, the Inter-American Investment Conference in New Orleans last year lifted the hopes of many Latin American businessmen that private dollars would be forthcoming if real incentives to invest were approved by their governments.

More than 150 American firms are ready now with plans to set up plants if and when the 14-percentage points reduction is passed by Congress.

Here is a country-by-country round-up of how recent action by overseas governments has altered the foreign tax picture:

Canada's exchange helps her

Narrowing of the premium of the Canadian dollar to par with U. S. currency adds to the inducement for American business to invest in Canada. On $1 million of earnings, a Canadian subsidiary of a U. S. corporation now pays a tax of $444,600, compared with $514,500 here on the same profit. However, the new law no longer permits a reduction from 15% to 5% on dividends paid out of "designated" surplus by Canadian resident corporations to a non-resident corporation. Because there is no capital gains tax in Canada, it is significant to note that many American firms are investing in non-resident-owned Canadian securities. Tax advantages by buying into this phase of investment trust organization became effective two years ago when the U. S. Government allowed sale of such Canadian funds to investors in this country. Profits are subject to the maximum 15% dividend tax.

The United Kingdom

The top tax surprise in Europe during the past year undoubtedly was action by the United Kingdom to reduce the standard rate for business enterprises. As a result of the drop in the basic tax rate to 42.5%,

an American branch or subsidiary in England that distributes all of its dividends pays a maximum levy of 62.9%. This includes recently increased tax on distributed profits of 30% and the surtax ranging from 10% to 50%. One American machinery manufacturer, who estimates earnings of $1 million in 1955-56, will pay a net tax of approximately $360,000 if the firm distributes two-thirds of its earnings in dividends. This is generally about the usual amount paid out to stockholders in Britain.

Actually, the corporate-profits tax, including the 3% assessment on undistributed earnings, comes to roughly $550,000. But because payments to stockholders are credited against personal taxes, the net tax to the subsidiary is reduced to $360,000. It is also well to remember that the parent firm here does not have to pay the 30% tax on distributed profits on funds remitted to non-resident companies under the clause exempting a non-resident from paying tax on dividends received from another non-resident company.

Belgium's favorable conditions

Among the many steps Belgium is taking to attract U. S. investors is a plan to give substantial subsidies for construction of industrial plants. Profits up to 30% of new capital invested in productive equipment are now exempted from taxation. Several U. S. firms are taking advantage of this allowance to offset the rather heavy tax bite on foreign corporate profits. These amount to the 40% flat rate, the 20% National Crisis Tax on profits distributed and the 30% Invested Capital Tax on dividends paid to shareholders.

Abrupt change in French situation

Less than a year ago France was one of the most profitable of all Western European nations for operation of an American enterprise. But the situation has changed abruptly and now scarcely any new investments are being made there by U. S. firms. Protests and strikes because of French antagonism to the present tax system have continually disrupted industry in recent months.

To make matters worse, the 8.5% royalty tax on earnings from French companies operating under U. S. license arrangement is being collected by the authorities. This has brought revenue protests from American firms and associations here. For nearly 30 years French tax officials ignored legislation authorizing such royalty taxes. Beginning in 1951 the Government started billing American investors. A formal protest lodged by the American Chamber of Commerce in France and by Washington regarded the French action as anything "but conducive to a good investment climate" and has now brought partial results. If the American licensor is the inventor of the patent, the 8.5% tax is not levied.

American enterprises will still have to pay France an estimated $2 million from revenue in addition to the $30 million collected from the 38% corporate tax—up 4% since June, 1955—and the 18% on distributed profits. The Paris Government has also tightened controls on the establishment of branches by U. S. parent companies. The goal is to reduce the number of American branches entitled to the 25% tax allowance on dividends remitted here under the tax treaty with the U. S. Subsidiaries were never permitted to take the 25% credit.

High depreciation in The Netherlands

American investors have started three-fourths of all the subsidiaries of foreign concerns established in the Netherlands since 1945. One of the chief reasons for the steady inflow of U. S. capital into Holland is the depreciation allowances, probably the most liberal found any place in the world. These deductions, which include the normal 10% depreciation, the 33-1/3% accelerated depreciation, and 4% annual deduction for investments, bring the total allowance over a five-year period to between 85% and 90%.

An American chemical firm, which made a 90,000 guilder ($23.7 million) original investment, took the permissible 39,600 guilder deduction the first year. In the next four years, it was allowed 38,400 guilders and from the sixth through the tenth year another 30,000 guilders, or a grand total of 108,000 guilders. This is 10,800 guilders more than the original cost of investment. However, if the U. S. manufacturer had sold the equipment at the end of the fifth year for 40,000 guilders against the designated book value of 30,000 guilders, a profit of 10,000 guilders ($2,630) would have been registered.

Denmark still attractive

American companies continue to find Denmark's lenient taxation schedules, which drop in assessment the longer the time of the investment, one of the most remunerative in Europe. Paying only 12% to 20%, depending on the income return in relation to capital, plus the new 25% surtax, they now find remittances easier to get as gold and dollars climb and the krone strengthens.

Italy: little progress

Despite serious efforts by the Scelba Government to draft a law favoring foreign investment in Italy, opposition from Leftists and other political groups will continue to stymie the entire program. During the past two years private American capital going to Italy has averaged only about $20 million annually so that the U. S. Government is cooperating intensely with Rome to get a workable law. Nine U. S. firms entered into licensing arrangements with Italian companies in the past year. But the recently-applied 22.5% withholding tax on two-thirds of royalty payments, which amount to 15%, is bound to discourage more companies from

similar setups. This levy is in addition to the regular 26.5% direct corporate tax, and the 0.75% levy on taxable assets plus 15% on profits in excess of 6% of assets. The 3% turnover tax is also being imposed on royalty payments. One encouraging step in Italy is the recent rise to 8% in amount of remittance permitted to be transferred out of the country annually on earnings from interest, profits, and other income from capital investment.

Healthy climate in West Germany

West Germany's three momentous steps within the past two years to attract U. S. investment places her on the threshold of a new era for obtaining industrial foreign capital. For the first time in history, and in direct contrast to the hazardous conditions existing less than two years ago, Germany is a healthy place for an American subsidiary to operate.

First, the slash in corporate taxes from 60% to 45% as of October, 1954 is the largest single postwar tax cut anywhere in the world. Second, ratification by the U. S. Senate of the tax treaty with Bonn avoids double taxation; reduces the tax on dividends to 15% when paid to American corporations; and exempts at the source bona fide interest on bonds, securities and royalties. Third, new measures issued by the Ministries of Economics and Finance permit all earnings to be freely transferable on approved investments.

Sweden

Sweden's recent authorization of a general 12% levy on capital investments in buildings and equipment is another example of the unwelcome attitude there for U. S. capital. A special purchase tax on autos and other vehicles also has been passed and a 10% hike in the profits tax has been imposed. Despite the reduction in the 20% Coupon Tax to 10% on dividends paid to American residents, the 52% corporate tax on joint stock companies is already high enough to hinder private U. S. companies when combined with other drawbacks.

Switzerland

Switzerland, too, has never relished large investment by American firms, even though corporate taxes are relatively low. A 20% surtax has been added to the 12% federal tax, but cantonal and communal levies come to another 25%.

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Results slow in Turkey

Turkey's series of investment-encouraging measures in the past few years has not yet begun to show real results. However, it may become the pattern for future decrees by other nations. Washington has advised nine countries—Afghanistan, Austria, Egypt, Formosa, Iran, Italy, Korea, Paraguay, and the Philippines—to use the liberal Turkish legislation as a yardstick in overhauling their foreign capital laws if they intend to lure U. S. dollars. The burdensome deficit at the European Payments Union still demands the bulk of Turkey's gold and dollar in settlement. American enterprises contemplating business there should be wary of a devaluation of the Turkish pound sooner or later. Goodyear Tire started a licensee project recently while a large U. S. match firm and a nut and bolt manufacturer both made direct investments.

Greece

American private capital is showing interest in Greece for the first time since the Thirties. One U. S. investor intends to build a match factory and a 400-room tourist hotel. A Canadian trust is also considering establishment of an aluminum plant, while the Dutch have offered to build a large shipbuilding yard. Taxes are lenient, with the rate 35% on both undistributed and distributed profits.

Iran and Iraq

In the Middle East, greatest focus has been on Iran during the past twelve months. To attract investors, the Teheran government has just approved a bill offering safeguards and inducements for foreign capital. One of the measure's most significant clauses is a guarantee against expropriation or nationalization. With revival of her oil industry, which will net her $250 million in 1956, Iran now feels she can underwrite large-scale foreign investments from oil income. Seven U. S. oil companies already have invested funds since settlement of the Anglo-Iranian dispute. Besides garnering additional petroleum capital, you can expect other American industries, especially in the capital and electrical equipment fields, to start branches in Iran before long. Companies pay a heavy 50% tax, plus a 10% levy on dividends. In contrast, the corporate tax is only 25% in Iraq, while manufacturing industries with initial expenses over 30,000 Iraqui dinars ($84,000) are temporarily exempted from taxes. However, absence of a wide consumer market indicates it is still more advantageous to export there than produce directly within the nation.

Licensing advantageous in Lebanon

Lebanon remains the number one attraction for licensee arrangements in the Middle East. U. S. manufacturers of machine tools and consumer durables are now in the process of concluding agreements to license their products. American enterprises directly estab-

lished in Lebanon are exempted from the regular 30% corporation tax for six years.

Jordan

Jordan has adopted a "Law for the Promotion and Encouragement of Industries" which will free profits from income and social welfare taxes for three years and allow a 50% reduction for two years.

Israel

Israel has extended the "Encouragement of Investments Law" to include corporations. Corporate companies, of which many of the country's largest are formed with American capital, are subject to the 50% Federal tax and 7.5% local tax, or a total of 53.75%, with 25% permitted to be set off from dividends distributed. Under the new Israeli law, foreign investors may take advantage of the maximum 26.875% tax concession for the first five years.

Liberia: answer to investor's dream

Liberia, undoubtedly one of the world's best havens for corporate organization, provides an answer to the U. S. investor's dream. Since 1954 over 100 American firms have created holding companies in this small Republic on the West Coast of Africa to take advantage of tax concessions and other benefits. First of all, absolutely no taxes are levied on income derived from sources outside of Liberia if the majority of the corporation's stock is held by non-citizens of Liberia.

In addition, there is a variety of other inducements to help the astute entrepreneur outwit his competitor. Absence of foreign exchange regulations, unlimited transfer of funds, no dividend or remittance levies, extremely liberal depreciation allowances up to 50%, speedy formation of corporations, as well as hidden identity of officers, directors and stockholders, are only a few.

The A. B. Company decided to form a Liberian corporation to act as its distributor in other nations. Its executives can be located anywhere desired—either inside or outside the U. S. It does not necessarily have to establish marketing subsidies in countries where a considerable potential exists for its items. The parent company sells goods made for foreign markets outright to the distributing subsidiary abroad, taking its manufacturing profits at that point.

As and when it makes subsequent sales to the various nations where it has dealer relationships, the distributing subsidiary accumulates its tax-free profits. Earnings built up by this distributor can be partially or wholly paid out as dividends to the home office. If preferred, they can be used for further expansion of the business in either the distribution or manufacturing field, or for a combination of both.

Another firm, the C. D. Company, organized a Liberian subsidiary as a holding company for a number of its profitable existing plants. The earnings of these branches are now being placed in an account of the newly formed Liberian company, which keeps them on deposit in New York, but as Liberian funds. This avoids both the income tax and the exchange risk. When new plants are desired, these funds will be withdrawn to pay for their construction.

Other African countries

We cannot help but note that withdrawal of British troops from the Suez Canal area is bringing increased foreign investments to Egypt. The Cairo Government has further liberalized law No. 156 of 1953 so that transfers of capital are greatly facilitated. Moreover, a new decree providing exemption from taxation on commercial and industrial profits for certain kinds of companies is receiving favorable attention. The object is to strengthen the national economy, with the 17% corporate tax waived for a seven-year period.

Several U. S. mining enterprises added to their huge investments in the Belgian Congo in the past year. The low 25% corporation tax—reduced by 25% if the profits are taxable in American—is only one of many incentives to lay out money in this once jungle territory. Company X—a large U. S. non-ferrous metal firm—paid a $375,000 tax on $2 million earnings from its Congo subsidiary in 1955, or an 18.75% aggregate assessment. Now other types of American enterprises are going into the Congo. One of this country's top three auto manufacturers is considering construction of a plant there.

Reduced taxes last year, more lenient depreciation and depletion allowances, and other heavy deductions, are the principal reasons why four U. S. mining companies made investments in Northern and Southern Rhodesia within recent months. Although corporate taxes actually are high, coming to as much as 52.5%, liberal deductions bring the average payment of U. S. enterprises down to 30%. The U. S. Foreign Operations Administration is endeavoring to get specific American projects started in the Federation of Rhodesia. Several joint ventures with Rhodesian capital are now possible.

The Union of South Africa has added an undistributed profits tax of 25% in addition to the maximum 50% Federal taxes and 12.5% provincial tax. These high taxes alone make it unprofitable for U. S. firms to operate in the Union. It is well known that political and labor difficulties add to the woes of the American investor. Despite a rapidly-expanding consumer market, soaring gold and uranium production, and increased dollar reserves, it is still preferable to export to South Africa instead of manufacturing there.

The Far East

Considerable progress is being made in the Far East to encourage private American capital. At least six nations recently have taken steps to attract U. S. investment.

American firms will not hesitate to invest in India once they receive a guarantee against expropriation, even though taxes are relatively complicated. Rebates to companies subject to the 26.25% normal rates and 29.7% supertax are liberal. Dividends received by companies which invest their surplus funds in certain selected industries are exempted from the corporation tax. In addition, the supertax is not levied on dividends in the hands of shareholder companies in the automobile, tractor, cement, electric motor, locomotive, rolling stock, machine tool, agricultural implement, ferromanganese, and dyestuff industries.

India will eventually sign an agreement with the U. S. to guarantee American investors against expropriation and assure them of convertibility of profits. Eagerness on the part of Indians to sign the pact is regarded as a way to show foreign investors that they have nothing to worry about. A new oil exploitation contract to Standard Vacuum and permission given Caltex to extend the East Indian Refinery project, along with decision of U. S. investors to subscribe $1 million in the Indian Industrial and Investment Corporation, are tip-offs of better days to come.

Pakistan added a 10% supertax to the 16.66% normal tax and 26.75% supertax but offset the hike with greater depreciation allowances and broad liberalization of investment laws. Companies controlled in the U. S. are granted substantial rebates, while the Pakistan Government will guarantee repatriation of capital in approved industries. This applies to profits which are plowed back into business and to capital gains. Negotiations with the U. S. to avoid double taxation will soon be concluded.

Ceylon, too, offers profitable ventures as her government now welcomes private funds from the U. S. "without attaching strings", in the hope of diversifying the country's industry. The Finance Minister recently assured foreign investors that no restrictions will be placed on their capital. Tax assessments are low in Ceylon.

Australia

New tax concessions, including larger depreciation allowances, are definitely expected to be granted in Australia during the 1956 fiscal year. However, further inducements to the 800 American firms already operating there most successfully are not necessary. Another 5,000 U. S. companies are interested in overseas investment in Australia, according to top officials in Canberra. Extension by Washington of the Contact Clearing House Service to Australia will expedite closing of hundreds of these deals within the next year or two. Atlas Corporation has signed an agreement to invest $1 million in a leading Australian uranium prospecting concern.

To reap the greatest benefit from low Australian taxes, American companies having a United Kingdom subsidiary would be wise to have the British company hold the shares in the Australian company. By doing this, under the double taxation agreement between Australia and Britain, there is complete waiver of the 35% Australian dividend tax paid to a United Kingdom parent company. On the other hand, a subsidiary of a U. S. corporation in Australia pays the 35% corporation tax and the parent firm also pays a 15% tax on dividends received.

Japan

Japan's basic attitude of discouraging U. S. investors through capital barriers has not changed, even though Washington was able to reach an agreement on double taxation. The exchange of instruments of ratification took place on April 1, 1955, and the new Convention applies to all income arising on or before January 1, 1955. Three key clauses will help American enterprises operating in Japan: (1) corporations in U. S. receiving dividends from Japan will receive 25% credit on dividends; (2) interest paid by American companies in Japan with respect to loans used in their Japanese branch is not taxable; and (3) the withholding tax is reduced to 15% on bonds, securities, royalties and other forms of indebtedness.

The deep-rooted Japanese fear of economic imperialism from outside impedes inducements to foreign capital. Financial assistance from Washington is much preferred to private U. S. investment. This is one reason corporate taxes are maintained at the high rates of 42% federal, 12% local "enterprise," and 12.5% municipal. However, the few American companies which invested heavily have been well rewarded. Caltex, Tidewater, and Standard Vacuum have tripled gross revenues since 1950.

Concerns such as Singer Sewing Machine, Parke-Davis, Johns-Manville, and Studebaker-Packard, which have set up joint partnerships with Japanese capital, have had sad experiences. Although the Big Three automobile manufacturers here have investigated the possibility of producing in Japan, they have abandoned the idea. Yet there is a definite trend for large American chemical companies, including Monsanto and Dow, to associate with Japanese firms. Dow has just opened a Tokyo sales office to promote its foreign-made products.

The Philippines

Elimination of the 17% remittance tax on dividends and other exchange transfers from the Philippines as of January 1, 1956, will inspire a rush of new private investment from the U. S. Ten groups of American investors visited Manila in 1955 to investigate specific projects on which they would spend a total of $40 million.

Furthermore, some 75 companies in the U. S. and abroad have plans to use a new process to manufacture soap from sugar. Colgate-Palmolive Company will be among the American companies which will prepare

these new products in the Philippines. These businesses will pay the very moderate corporate tax of 20% on the first 100,000 pesos ($50,000) and 28% over that amount unless they are exempted from taxes through 1958 under the law allowing "new and necessary" industries complete tax freedom. Djkarta still has no intention of abolishing the 66.66% remittance tax in Indonesia so you can expect other U. S. firms in addition to General Motors to withdraw from the country.

Argentina

Since 1945 less than 2% of earned income of U. S. enterprises in Argentina has been permitted to be transferred here by the Government. Of course, this does not consider the $150 million of capital repatriated by American companies forced to liquidate in the early postwar period. Actually, 5% of total investment is allowed to be remitted annually, although a new decree last year extended the 1953 investment law "to old established capital" so that any foreign-owned firm can remit 8% of capital annually after being in business two years. However, that measure actually was not a major step forward, since it applies only to "national interest" industries. It is believed that the new government will be more favorable to American business.

Brazil

Even though Rio de Janeiro is confronted with a severe dollar shortage due to low coffee prices here, and further devaluations of the cruzeiro are certain, U. S. companies still find that their most profitable Latin American operations are in Brazil. Of the 156 U. S. concerns with investments in Brazil, 46 companies, ranging from a joint W. R. Grace-American Home Products chemical venture to a Higgins shipyard, took the step in the past year. Actually, few firms have found difficulty in getting dollar remittances out of the free market, although the exchange premium is exorbitant.

The former Cafe Filho Administration increased taxes in a six-pronged measure that adds appreciably to total corporate tax assessments. As a result of a hike in the commercial profits tax to a flat 15%, an additional 4% levy on profits over 500,000 cruzeiros ($27,025), and a 5% jump to 20% in the non-resident tax and to 25% on bearer share dividends, the branch of the American retail merchandise firm which paid a $563,000 tax last year on a $2 million profit would now pay nearly $600,000. This makes the aggregate tax about 30%.

Bolivia & Chile

Bolivia eased regulations on foreign oil and tin ventures so that she now banks on production gains to lift the burden of inflation. Chile revised her laws to boost copper output and give U. S. firms a much fairer deal. Basic corporate tax now is 50% in both nations, with an additional 25% surtax in Chile which may be scaled down to zero as copper production increases. Seven American firms intend to increase outlays because of the lower taxes. Santiago also approved a decree giving foreign investment equal treatment to domestic capital.

Paraguay

Paraguay's new investment law allows for a 25% reduction for a period ranging from five to ten years on an already low corporate tax of 20%. U. S. investors, who are participating with Paraguayan shareholders in developing huge coffee plantations which will double that country's earnings in three years, will benefit from the lowered rate.

Ecuador & Peru

Ecuador and Peru are the two latest countries to have signed agreements with the Foreign Operations Administration whereby U. S. investments can be insured against inconvertibility and expropriation. In both countries normal corporate taxes are only about 20%, with an additional 20% excess profits tax in Peru.

Venezuela

Venezuela, the country with the second lowest tax in Latin America, amounting to a 3% basic levy and a surtax up to 26%, still presents no problems to U. S. enterprise other than those arising from the tight credit restrictions there. Curacao, the wealthy Netherlands Antilles island off Venezuela, has a free port in operation.

Colombia

Colombia, still with one of the highest tax structures of the Latin Republics, remains blind to American investment possibilities. The two U. S. construction firms which is building a housing project for 4,000 families in Bogota could be assessed as much as 60%, depending on the return on investment. Although Colombia did raise the depletion allowance recently to 35%, the incentive to such U. S. oil companies in Colombia as Shell, the Texas-Socony group, and Standard of New Jersey is nil. These petroleum giants would prefer adding capital in Peru and Venezuela, where the allowance is 50%. The only hope in Colombia to stimulate investment is the proposed double-taxation agreement with U. S. This is likely to be completed soon after the first of the Latin American treaties with Honduras is signed, which should be momentarily.

Honduras

In the Republic of Honduras—a relatively unexploited country no larger than the State of Pennsylvania—one finds probably the world's perfect tax paradise for investors from the U. S. Honduras may right-

fully be placed at the top of the leading tax shelters because of a triple-barreled incentive plan for foreign investment that is unique.

First, a progressive regulation of long standing exempts non-resident companies from payment of taxes on income derived from sources outside of Honduras. Moreover, an important offshoot of the Republic's basic tax laws has been unwittingly overlooked by American businessmen much too long. Specifically, any U. S. citizen or company with no official residence in Honduras is not taxed by the latter on dividends received from a Honduran corporation.

Second, Honduras is the only tax haven in the world where American firms or individual may obtain investment guarantees from the U. S. government. A pact signed with the International Cooperation Administration in 1955 protects business ventures against (1) currency inconvertibility and (2) expropriation.

Third, negotiations have been concluded between Honduras and the U. S. for a double-taxation convention—the only one among the ten tax paradises found on the globe. The agreement provides that profits earned within Honduras by American corporations will not be taxed by the U. S. Plans are already afoot to extend the treaty so that dividends, interest, and royalties remitted to U. S. residents will be limited to 15% if the payee does not have a permanent establishment in Honduras. In addition, Honduras is prepared to grant to U. S. corporations tax concessions which seldom can be matched anywhere in Latin America, Europe, and Africa. For instance, a recent example of what this incentive might include is the offer to a leading Midwestern farm-machinery company to enjoy complete tax freedom for a 30-year period should the firm decide to set up a Honduran branch for manufacturing, assembling, or distribution there.

Panama

Panama probably became one of the principal tax paradises in the world during the past year, exceeding both Liechtenstein and Liberia in the number of foreign holding companies established there. At present there are over 10,000 of these externally-owned corporations enjoying complete tax freedom on all income earned from sources outside of Panama. If you conduct your export operations through a Panamanian company, you will not only save on taxes but you will enjoy numerous legal advantages, absence of documentary fees, freely interchangeable currency, no foreign exchange restrictions, fine ports and abundance of intelligent but cheap labor. It is reliably reported that savings by one of the "Big Three" U. S. automobile firms through operations out of its Panama company ran to eight figures in 1954. One of the chief reasons that a leading American pharmaceutical company increased foreign sales volume by 33% was use of Panama as a business center for its companies throughout the world.

Several large American firms have formed corporations in Panama just to use a 100-cent dollar for legitimate and necessary real estate, office, salary, and capital-equipment expenditures throughout the world. If the money is spent by a parent firm in the U. S., the transaction, of course, is made with a 48-cent dollar, since the corporate tax of 52% here has been deducted from earnings.

An American publishing house issues a foreign edition of a magazine which is sold and distributed entirely outside of the U. S. The publishers sell the magazine to their Panama subsidiary which sells advertising space to American exporters, thereby substantially reducing the U. S. tax. Another American firm built a plant in Brazil but wished to protect profits from exchange risks and U. S. taxes. The parent company formed a Panama subsidiary to serve as a holding company for the Brazilian operation and accumulated its profits free of all taxes.

Other Central American countries

Costa Rica, however, has just increased her corporation profits tax to a maximum of 30%. Nicaragua's new liberal law covering many phases of foreign investment, including free remittance of capital and profits, gives U. S. firms equal treatment in tax and labor laws. Highest levy on corporation income is 18%. Guatemala has eliminated the so-called absentee tax on profits and signed an investment guarantee agreement with the U. S. Foreign Operations Administration.

Cuba has created a new free trade zone 60 miles east of Havana for industrial and manufacturing establishments and has approved a tax-incentive investment law which Secretary of Treasury Humphrey says is "ideal" for U. S. enterprise. Qualifying industries get a 6-year tax exemption on interest and loans; a 10-year waiver on dividend tax; partial exemption from the profits tax on income not in excess of 10% of capital; and a 40% reduction in the excess profits tax.

The industry shift from U. S. to Puerto Rico is gaining momentum. About 350 plants have been established on the Island since the Puerto Rican Government undertook its campaign to attract American industry. Practically all enjoy 100% tax exemption for ten years, although many do not qualify for U. S. federal income tax credit since 80% of the total net income has not been derived in Puerto Rico for three years before the taxable year. An Ohio firm expects to increase its net profit from $187,000 to $442,000 a year by locating its new plant in Puerto Rico. A complete revision of the excise-tax structure eliminating duties on 162 articles of general consumer goods has been recommended. On the other hand, a progressive tax progressing from 26% to 35% has been placed on automobiles. ☆

THE TAXATION OF INDIVIDUALS

Personal tax problems

EDITED BY BENJAMIN HARROW, J.D., CPA

Intra-family debts can cut taxes, but good planning is necessary to get deduction

DEBTS HAVE the same tax advantage to members of a family group that they do to an owner who lends to his corporation: (1) the interest is dedeductible, thus making it possible either to transfer money tax free or to shift the tax burden from a high-bracket to a low-bracket taxpayer, and (2) repayment of the loan enables money to be recovered by the lender tax free.

The taxpayer lost in one recent case (*Mercil*, 24 TL 130) of this nature, and from an examination of the record it looks as though he probably should have. But in this decision are the seeds of caution, and a lesson for the tax planner who wants to undertake such a maneuver. This case concerned the question of whether the cost of a college and medical education to a father can be considered a debt due from a son. Can the son twenty years later make payments to the father and can such payments be considered deductible interest? That was the issue before the tax court in *Mercil*, and under the circumstances there present the court said no.

A father had financed the college and medical education of his son. This included $20 received from the father for a trip to Duluth and $99.50 for the purchase of a suit and overcoat on December 24, 1927. The father had also financed the college education of his three daughters. The amounts advanced to the son were contained on a sheet in a ledger. They were made after the end of each school year, and purported to cover the aggregate advances made during the year. The account was closed by a credit entry of $5,164.39, on February 11, 1929 that being the total advances. A new debit balance was entered and described "To Bal. Date of Marriage." (the taxpayer was married in that month).

In 1945 the father suffered a fractured hip. A hospital bill of $560 was paid by the son and starting with October he began paying his father $100 each month. At this point the taxpayer, his father, or someone, began showing signs of tax consciousness, for under date of March 11, 1946 the father prepared an account stated with the son. It showed a principal amount of $5,164 and to this was added "interest at 5% from December 22, 1927 to August 4, 1945"—$5,664. Additional items thereafter were added for interest. Against the indebtedness were credits for the hospital bill of $560 and the $100 payments. Interest was reduced from 5% to 4% on January 1, 1946, and this was compounded monthly. For 1946 the father reported the so-called interest payments as income.

In his decision Judge Turner said that there must first be an indebtedness on which the interest is paid, and for that there must be a debtor-creditor status, and an unconditional obligation to pay. The son claimed that it was the intention at the time his father made the advances that he should be obligated to repay on demand and with interest. He claimed further that in 1945 his father made such demand and that the monthly payments were intended to be payments of the interest.

Not arm's-length transaction

Judge Turner begins by stating that the transaction was not at arm's length, it being between father and son, "and being so, it is subject to rigid scrutiny for the purpose of determining its actualities." That is not a new doctrine. Judge Turner adds that there is a presumption in the law that property transferred by a parent to a child is a gift or advancement, and not a loan. In dealings between a father and child that is something one should remember. The court cites a New Jersey case *Bankers Trust Co. v. Bank of Rockville Center Trust Co.* 168 Atl. 733) wherein the court said "To overcome such presumption of gift from a father to a son, the proof offered to accomplish it must be certain, definite, reliable, and convincing, and leave no doubt as to the intention of the parties."

In this case the court held that the presumption was not overcome. Rather after 20 years when conditions and circumstances were drastically changed, father and son were attempting to reconstruct and fill in understandings had when the son was a minor that an indebtedness was created through the financing of the son's education. There was no written agreement, no note or other written evidence of indebtedness, and no understanding as to the rate of interest. Taxpayers should take note of these factors in building up a good basis for an interest deduction in similar situations.

The writings in the father's ledger showed similar records of advances to the three daughters but as to them no interest had been charged. The court further held that the keeping of ledger sheets was "in no way persuasive of the conclusion that the expenditures made were loans rather than advancements." It was most desirable to have a record of transfers of money by a parent to his children. The son had testified that he was obligated to repay the advances with interest on demand. The father had testified that the promise to repay was conditioned on his becoming able to pay. This, said the court, does not create an indebtedness, until the specified condition is satisfied. Said the court, ". . . we are not advised as to just how and in what terms the demand was made, and we find no proof directed to petitioner's ability to repay, when and if demand was made." Two lawyers represented the taxpayer but evidently the case could have been better prepared. The court also notes that only a small fraction of the advances and interest was paid, so that the son was still unable to pay the father.

The court further concludes that on the evidence there was never an unconditional liability to repay. In addition the court notes that an arrangement to convert the advancements into indebtedness can not be enforced under Minnesota law since an advancement if a gift and a promise by the donee to repay it is without consideration.

In his careful analysis of the testimony

the Judge notes the statement of the father that he would never have enforced payment by the son. That is not the normal thing in a debtor-creditor relationship comments the court. But wouldn't that be a normal thing in a father-son relationship? The son had testified that even if there was no claim of debt he would have paid his father's hospital bill and have made the monthly payments. This the court thought was revealing in the establishment of a debtor-creditor relationship. Also the court thought it was significant that $99.50 of the claimed indebtedness covered the cost of a suit and overcoat while the son was an intern. The money was received on the day before Christmas. In the account the father kept, a balance was struck at about the time the son was married and the entry was described by the words "To Bal. Date of Marriage." The court probably was left with the inference that if there ever was a debt it was written off as a marriage gift.

Finally the judge in his gentle skepticism says that the computation of alleged interest was not made until about March 11, 1946. Says the Court. "It is quite likely, we think, that this statement prepared by petitioner's father under date of March 11, 1946, could have supplied the basis for the entries made on the ledger sheet, and, if so, could be some further indication that the concept of unconditional liability for the principal sums carrying with it the claim of interest, did not crystallize until after the father's need arose and sometime after the hospital bill and a number of the monthly payments had been made. Due to the vagaries of the human memory, it is often most difficult, when recalling an occurrence of the past, to avoid and refrain from casting it in the form to which it appears best suited at the time of remembering."

Interest is an allowable deduction and it is allowed even in connection with a personal transaction. But there must be a debt upon which interest is being paid. Gifts and advancements do not create debts and so-called interest payments on such advancements do not give rise to a tax deduction. ☆

Watch for hidden tax trap in mutual funds

EVERETT J. MANN, in *How to Make Money on the Stock Market* (New York, Macmillan, 1955,), sounded this note of caution about investing in mutual funds:

"Few investors realize they may be buying contingent tax liabilities when they purchase mutual fund shares. Since the investment trusts sell at net asset values, the purchaser pays the going market price. The funds themselves may have acquired the securities currently in their portfolios at prices lower than those prevailing when the new shareholder buys.

"As an example, let it be supposed that an investor buys mutual fund shares at 65. The investments owned by the fund were acquired when the shares were selling at 30, a not unusual situation during strong markets. Today's purchaser pays a price over 70 (65 plus an 8% loading charge). If the fund were to liquidate its investments immediately, the shareholder would have to *pay a capital-gains tax on the 35 points of accumulated appreciation from which he got no benefit.* His income tax, computed at the maximum 25% rate, would amount to almost 9 points, making a total price of about 79 to be paid for assets worth only 65. (As regulated investment companies, mutual funds themselves pay little or no income tax.)

"If the value of the fund shares were to drop to 60, the owner would have suffered a capital loss. Nevertheless, he would be in the peculiar position of having to pay an income tax if the fund were liquidated at 60. This tax trap is one into which any mutual fund purchaser could fall." ☆

Transferee liability on life-insurance proceeds seem clearly limited to cash value

THROUGHOUT THE CONFUSION over the tax status of life-insurance proceeds it is possible to trace a strong line of agreement on transferee liability for taxes, says Philip J. Erbacher in 31 *Kansas City Bar Journal* No. 2. According to Mr. Erbacher's analysis of the circuit court cases, the beneficiary's liability for the decedent's unpaid taxes, etc., is governed by state law, and not by federal court decisions. (As noted in the *Wendell* case (4 JTAX 287), the Tax Court is continuing to follow the rule that federal law governs and that the liability is not limited to the cash-surrender value.) His explanation:

Legal history

A line of Tax Court cases—*Bales,* 22 TC 335, *Rowen,* 18 TC 874, *Muller,* 10 TC 678, *Pearlman,* 4 TC 34—stand for the general proposition that the beneficiary who receives the proceeds of a life-insurance policy in which the insolvent decedent retained incidents of ownership is a transferee within the meaning of Section 311 (f) of the 1939 Code: "The beneficiary is liable [to the extent of] the proceeds of the policy for unpaid income taxes, interest, etc., of the decedent."

The Tax Court decisions collectively appear to rest on the decisions of *Pearlman v. Comm.,* 153 F.2d 560, and *Kieferdorf v. Comm.,* 142 F.2d 723, *cert. den.* 323 U.S. 733. In the *Pearlman* case, the Court of Appeals took the view that the matter was to be decided under federal law, and not under state law.

The law would thus appear to be reasonably clear. However, along comes *Rowen,* where the court held:

1. Beneficiaries of the policies at issue *were not transferees* of the decedent as to *proceeds* of the policies, since the proceeds were never the property of the decedent.

2. Beneficiaries *were transferees* of decedent *as to the cash surrender value of policies,* since said value was once the property of the decedent.

3. The question of whether the beneficiary was under "liability at law or in equity" for decedent's unpaid income taxes was to be determined by *state law.*

In *Tyson v. Comm'r.,* 212 F.2d 15, CA-6, the court held the (wife) beneficiary of the life insurance policy on her husband not liable as transferee for husband's unpaid income taxes. The husband died solvent, he had retained incidents of ownership, and the policy had no cash-surrender value.

In *United States v. New,* 217 F.2d 166, CA-7, the court followed the *Rowen* decision in a case involving only proceeds of the policy, cash value being ignored. The court stated, "The issue . . . is whether the beneficiary of a life-insurance policy, of which the insured had retained the right to change the beneficiary, is liable for delinquent income taxes of the insured to the extent of

the proceeds of the policy, the insured having died insolvent." The court said that the weight of authority was against the government's position, and cited the *Rowen* case, stating: "In no sense were the proceeds ever property of the decedent . . . ."

United States v. Truax, 233 F.2d 229, CA-5, involved the government's attempt to collect the husband's unpaid income taxes from the widow of a deceased insolvent taxpayer. The Trial Court gave judgment to the extent of the cash-surrender value to the government. The appeals court affirmed the lower court judgment since the widow had not appealed, but held that the government position was wrong because under Georgia law there was no liability at law or in equity except to the extent of the amount of premiums fraudulently paid. In the course of its opinion the court stated:

". . . We think it is quite significant also that the government has indicated that in regard to the *New* and *Rowen* cases, applications by the government for certiorari have not been authorized by the Justice Department, nor does the Justice Department contemplate taking the cases to the Supreme Court. We observe also that the holding in *Rowen* that state law is applicable and that the beneficiary is not liable for the entire proceeds of the insurance has met with approval in the legal periodicals."

Based on the thinking in the *New, Rowen, Tyson,* and *Truax* cases, it appears that the life-insurance beneficiary's liability for income taxes of the owner of the policy at death is limited at most to cash-surrender value at date of transfer (death), and that as to that amount her liability depends upon state law. ☆

Two questions when alimony is paid by trust

THE CODE HAS specific rules for taxing alimony (Section 71) and also rules for taxing trust beneficiaries (Section 682). What happens when alimony payments are made by a trust? Donald McDonald of the Philadelphia law firm of Montgomery, McCracken, Walker & Rhodes, recently explained this situation succinctly (in 17 *U. of Pitts. L.R.* 11). Here is a quotation from the applicable portion of his paper:

There is a very broad overlap between Sections 71 and 682. Sections 71 (a) (1) and 71 (a) (2) treat as an alimony payment those payments attributable to property transferred in trust or otherwise in discharge of the legal obligation imposed by the marital or family relationship. Then Section 71 (d) adds that no part of the income from property transferred in satisfaction of these obligations shall be taxed to the husband. It treats the annual trust income as a periodic payment fully taxable to the wife. A separate section also covers the taxation of a wife on income from a trust after she is divorced from her husband. If the income of a trust is payable to her, Section 682 makes it taxable to the wife, even though it would otherwise be taxable to the husband, either because the trust is revocable or for a short term, or because the income is applied for his benefit, or he has wide supervisory powers. It is easy to forget that Section 71 can apply at the same time.

There are two very important distinctions. It may be that the trust was created without any thought of a divorce, and at the time of the divorce or separation no one is willing to modify it. Section 682 then becomes important, because it has no requirement in it that the trust be created or the property transferred incident to a separation or divorce. The other very important difference is a variation from the normal taxation of trust income to the trust beneficiary. Under the new Code, if there is an obligation to pay a fixed amount, such as $5,000 a year, and the trust income only comes to $4,000, $1,000 will come from corpus. Under the normal rules of trust taxation, the beneficiary would be taxed on only $4,000 and the additional payment out of corpus would be tax-free. In addition, under the new Code if there are deductible items paid out of corpus, such as certain taxes and attorney's fees in the administration of an estate, so that the net taxable income on the fiduciary returns is less than the actual dollars paid out to the beneficiary as income under state law, no more than the net taxable income shown on the return is taxable to the beneficiary. In both these cases, either because there are payments made directly to the beneficiary wife from corpus, or because items deductible in computing net income of the trust are paid from corpus, the wife beneficiary receives more money than is taxable to her under the rules applicable to trusts and beneficiaries. However, if the trust is incident to a decree or agreement, so that it is also governed by Section 71, the alimony rules take precedence over the trust rules and the wife becomes taxable at ordinary income rates upon the entire amount paid to her, even though part of the payment either directly or indirectly is paid out of principal.

If alimony is being paid from a trust, the trust rules do continue to determine *when* she is taxable. If the trust is on a tax year different from the wife's, she includes all payments made at any time during the trust's year in her tax year in which the trust year ends. For example, if the wife is on a calendar year and the alimony trust tax year ends January 31st, she will include in her income tax return for her year 1956 all the payments which she received from the trust from February 1955 through January 1956. She will not include in her 1956 return the payments from the trust in February through December of 1956.

To the extent that a wife is charged with ordinary income which is paid in fact from the principal of a trust, the husband on his return should be entitled logically to a deduction under Section 215. This deduction certainly should be available if he has a substantial reversion in the trust principal or if he may revoke the trust.

Finally, it should be noted that the overlap between Section 71 and Section 682 arises only when the trust is incident to the decree or agreement of separation or divorce. ☆

U. S. naval officers have tax advantage over British

U.S. NAVAL OFFICERS can now deduct the cost of their mess bills while afloat, according to a new Revenue Ruling. But in the same mail we received the current issue of *Taxation* from London, which quotes Mr. Justice Vaisey regarding the officer's claim in respect of mess subscriptions and share of mess guests' expenditure for the year:

"No doubt the respondent was under an obligation to make his proper contribution to this as well as to the mess funds. But both payments must, in my judgment, be referable more to his personal and social obligations than to the performance of his official duties. It is, to my mind, irrelevant to say that he would have been asked to resign his commission if he had refused to incur this expenditure. The same consequence

would presumably have ensued if he had omitted to procure and wear decent civilian clothing when not in uniform, but that consideration would not have justified an allowance under the rule in respect of his ordinary tailor's bill."

When they hear of this new Revenue Ruling the officers of Her Majesty's Senior Service will be vexed anew with the gentlemen in Somerset House! ☆

Expense accounts average $28.33 per day in cities

THE MAGAZINE SALES MANAGEMENT has made a study and found that executives visiting large cities turned in an expense account averaging $28.33 per day; in smaller communities it was $20.76 for executives. Salesmen average $16.53 per day. The study doesn't tell us whether this includes transportation or not.

New decisions affecting individuals

Legal fees for divorce proceedings not deductible. Payments by a husband for attorney fees and court costs in connection with the divorce proceedings and property settlement between himself and his wife were held to be personal expenditures. Taxpayer did not show what costs, if any, were attributable to the property settlement. Therefore, the court said, it would not consider whether such fees would be deductible. The husband was also denied a deduction in 1953 for payments of alimony *pendente lite,* prior to the entering of the divorce decree. *Paton,* TCM 1956-111.

Support of minor children, dental expenses, and insurance premiums not deductible as alimony. A separation agreement provided that the husband pay $230 a month for the support of the wife and children with the proviso that if the wife should remarry the husband would pay only $125 per month for the children's support. The difference, $105, was held deductible as alimony. Payments for the wife's dental expenses were not deductible since they failed to qualify as "periodic payments." Neither could the husband deduct insurance premiums on a policy in which the wife was named as beneficiary as her rights were contingent upon nonremarriage and survival. *Fisher,* TCM 1956-98.

Trip from St. Louis to Tulsa to see doctor deductible. [*Acquiescence*] Taxpayer, a retired engineer in his 70's living in St. Louis, suffered from generalized arteriosclerosis. Trips to Tulsa, Oklahoma, by taxpayer and his wife to visit their eye doctor were deductible as medical expenses. *Rodgers,* 25 TC No. 36, *acq.* IRB 1956-18.

Mother who is student can't deduct for child care. Child-care expenses paid by a taxpayer for the purpose of enabling her to continue her studies or education do not qualify as deductible "child care" expenses to enable "taxpayer to be gainfully employed." *Rev. Rul.* 56-169.

Wife's nephew not dependent on husband's separate return. A husband can not claim his wife's nephew as a dependent on his separate return even though the nephew was placed in his home for convalescent care pursuant to an agreement with the Department of Mental Health; the agreement was not the equivalent to adoption. *Grossman,* 26 TC No. 26.

Accident expenses not deductible; was on personal, not business, trip. While driving home at 3 a.m., taxpayer, a corporate officer and salesman, injured a pedestrian. Taxpayer claimed the resultant expenses as business-expense deductions on the ground that when the accident occurred he was on his way home to prepare for a business trip. The court finds that he was only on his way home from work and that he was not engaged in any trade or business, or in the production of income, at the time of the accident. *Henke,* DC Ill., 3/30/56.

Cost of sending problem child to school not a medical expense. The court disallowed as medical expenses the cost of ending taxpayers' son to a boys' school recommended by the family physician to improve his outlook on life and correct a "psychosomatic" condition. The court said, "To hold otherwise would, we think, open the door to excessive abuses. It is common knowledge that problem children are not rare and that the proper home surroundings and parental discipline furnish efficient and adequate correctives. The record shows that both the petitioners were employed and spent nearly every evening away from home. That improvement would result from a change in environment and association would seem to be a normal and natural expectation. Peter was not an incorrigible child. That his mental attitude improved does not serve to make the expenditure deductible as a medical expense."

Taxpayer and his wife worked for an antique dealer and reported total salaries of $8,800. Of the $3,000 claimed for business expenses (entertaining, promotion, etc.), the court disallowed $1,400 as unsupported and "patently lavish and exorbitant in proportion to gross income." *Pascal,* TCM 1956-83.

DEPENDENCY DEDUCTIONS

Can't get a deduction for a vacation trip. A taxpayer who makes a business trip or attends a business or professional convention, and as an incident to such trip engages in personal vacation, can deduct only that part of the cost of the trip attributable to business. If his wife accompanies him, her travel expenses are not deductible unless her presence has a bona fide business purpose. If a trip is primarily personal, the entire expense is nondeductible even though taxpayer participates in some incidental business activity. *Rev. Rul.* 56-168.

No rental loss on premises leased to brother-in-law. Taxpayer leased a portion of his house containing four rooms to his brother-in-law for $40 a month. The court determined that the expenses allocable to the leased premises were not in excess of the total rentals received, and disallowed a claimed rental loss. *Scala,* TCM 1956-100.

Entertainer can deduct costs of libel action to protect his income. Paul Draper, a professional dancer, incurred legal fees as plaintiff in a libel action against Hester McCullough for circulating statements that he, Draper, was procommunist. The action was brought for the sole purpose of vindicating taxpayer's personal reputation and character so that he could continue successfully as a public entertainer. His income was found to have dropped sharply after the adverse publicity. The court held the fees deductible as necessary business expenses. It said that where the primary purpose of litigation is to vindicate the personal reputation and

character of a taxpayer, the costs are not deductible. Here, however, taxpayer's sole concern was with his continued business success as a public performer. *Paul Draper,* 26 TC No. 22.

Expenses allowed for boat held for charter. In 1949, the taxable year, taxpayer expended a considerable amount to fully convert his boat to charter use but was unable to so use it because of its seizure and sale for satisfaction of certain outstanding liens against him. The Commissioner argued it was a pleasure boat only in that year. The court held that taxpayer was engaged in the business of chartering in 1949 and allowed deductions for wages, maintenance, and a portion of the claimed repairs. In determining taxpayer's basis for loss on sale the court considered only the original cost less allowances for depreciation, since taxpayer failed to offer any proof of capital expenditures. *Bruce,* TCM 1956-96.

Had reasonable cause for not filing estimate; failure to file eliminates penalty for underestimation (old law). Taxpayers sought the advice of competent tax accountant who advised them that there was no need to file declarations of estimated tax. The government conceded reasonable cause but contended that only the filing of a declaration could satisfy the statute. Existence of a reasonable cause, says the court, eliminates the penalty. In addition, the court followed the *Ridley* case, DC Ga., 1954, and held that since no declaration was filed there can be no penalty for underestimation. [The Commissioner has announced that he will not follow the *Ridley* case. The 1954 Code imposes penalty only for failure to pay. *Ed.*] *Jones,* DC Ariz., 4/25/56.

Occasional gambler can't take deduction for gambling losses. Taxpayer who gambled "occasionally" failed to keep records of his gambling wins and losses. For failure of proof the Commissioner's determination of his winnings for 1948 was sustained. As taxpayer was not in the business of gambling, he was not permitted to deduct gambling losses in arriving at his adjusted gross income. Neither could he take the gambling losses as a deduction from adjusted gross income since he had elected the standard deduction on his 1948 return and was precluded from revoking such election. [For taxable years after 1949 the election may be changed any time within the statute of limitations. *Ed.*] *Hixon,* TCM 1956-106.

Right to standard deduction not affected by disallowance of "business" expenses. Improperly taking deductions from gross income in arriving at adjusted gross income has no effect on the election to take the standard deduction. Accordingly, though taxpayer claimed items as business expenses which the court found could have been taken only as itemized deductions, he did not forfeit his duly elected standard deduction. *Miller,* 26 TC No. 16.

Not "away from home" while on jobs of indefinite duration. Taxpayer, who was unmarried, worked as a telephone installer for Western Electric on New York City installations. Prior to going to Baltimore for his company in January, 1949, he lived with his stepmother and sister, and helped pay the rent of the apartment. He stopped doing this as soon as he was transferred away from New York. His assignments during 1949 and 1950 were of indefinite duration in several cities in Maryland and New Jersey. The court held his home was at the place of employment and disallowed the claimed traveling expenses, including meals and lodging. *Burns,* TCM 1956-84.

Maryland income tax now pay-as-you-go; deductible when paid. A cash-basis taxpayer who does not elect the standard deduction may deduct the amount of Maryland state income tax withheld from his salary or paid as an estimated tax in the taxable year withheld and/or paid. *Rev. Rul.* 56-124.

Local adjudication of community-property interest binding on Tax Court. Taxpayer contended she did not establish domicile in Texas although her husband may have, and consequently the income received by her husband for managing three Texas newspapers was improperly reported on a community basis. The Tax Court holds that the ownership of his income was determined by the laws of his domicile, Texas, and further, the specific point had been determined by a Texas court which in the course of divorce proceedings judicially determined that there was a substantial amount of community property. The husband's income had been correctly reported as community income. *Owens,* 26 TC No. 7.

RECENT DECISIONS ON FRAUD & NEGLIGENCE

Lien on corporate funds prevents hiring accountants, but proper because individual defendants have funds. A corporation and three of its officers were indicted for tax evasion. Two months earlier, federal tax liens had been filed against all of the corporation's assets, and it is now contended that the corporation is being deprived of due process of law because it has no funds to pay accountants. The court disagrees. The individual defendants had funds to pay for accountants, and the alleged fraud of the corporation and the individuals involve the same transactions. The court noted that in any event it did not agree with the *Brodson* case (DC Wisc.) that impounding taxpayer's funds so that he could not hire accountants was a denial of due process. This court raises the question whether the court could not appoint an expert. *Allied Stevedoring Corporation,* DC NY, 1/31/56.

Substantial understatement evidences fraud; penalty applies to voluntary payments. The consistent understatement of substantial income by an experienced businessman over a period of years, coupled with his failure to offer any tenable explanations for the omissions, is held to evidence a fraudulent intent to evade tax. No merit was found in taxpayer's argument that the 50% fraud penalty could not be applied to the entire deficiency where part was voluntarily paid prior to the deficiency notice. *Romm,* TCM 1956-104.

Can't use voluntarily-disclosed evidence for criminal prosecution (old law). After taxpayer's returns for 1943 and 1944 had been examined and settled, taxpayer wrote a letter disclosing that his returns from 1943 to 1946 were in error and claiming a voluntary disclosure. He was indicted for criminal evasion of 1945 and 1946 taxes. The court holds that as to those years the disclosure was made prior to the beginning of investigation. It therefore suppressed the evidence obtained after the letter was sent. The reference to 1943 and 1944 was irrelevant. [The Commissioner no longer follows the policy of not recommending criminal action if voluntary disclosure is made prior to the beginning of investigation. *Ed.*] *Pack,* DC Dela., 3/16/56.

NEW DEVELOPMENTS IN TAX ASPECTS OF

Accounting

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Claim-of-right and other tax doctrines are distorting proper accounting

by **JAMES H. HEFFERN**

The fight to make accounting for tax purposes stop doing violence to good accepted commercial accounting methods was not altogether lost with the repeal of Sections 452 and 462. Without these sections,, the claim-of-right doctrine seems to be the heart of the difficulty. Now claim-of-right is faltering a bit. Taking a cue from recent decisions, the taxpayer has a better than even chance of making his own established and proper accounting method stand up against the Commissioner's assertion of claim-of-right. This article explores the present situation, and analyzes the new decisions upon which the more hopeful picture is based, with regard to prepaid income, and also accrued expenses and changes in accounting methods.

THE CLAIM-OF-RIGHT doctrine as it operates today under the 1954 Code is of especial importance in view of the recent repeal of Sections 452 and 462. The effort by accountants to bring tax accounting into harmony with generally accepted commercial practice suffered a blow with this repeal. But one consequence of that repeal is the increased emphasis it puts on the claim-of-right doctrine as an obstacle to proper accrual of income and expense for tax purposes.

The claim-of-right section is interesting, not as a specific section but because of the broad picture of accounting methods raised by some recent cases in which the claim-of-right doctrine was relied upon. The first is *Beacon Publishing Co. v. Commissioner,* 218 F.2d 697 (CA-10), reversing 21 TC 610, where a daily newspaper on the accrual basis had reported income from prepaid subscriptions as it was received. Apparently the amount was not great until 1942, when it put on an intensive campaign to obtain prepaid subscriptions for from 30 days to 5 years. In 1943, an accounting firm was retained to prepare a statement. Without consent of the Commissioner, the firm deferred part of these subscriptions. The Commissioner disallowed the deferment and included the full amount of the subscriptions in the year of receipt. His reason was that they were received under a claim of right. The Tax Court, in an opinion based principally on claim of right, decided in favor of the Commissioner. The Court of Appeals reversed the Tax Court, pointing out that the Tax Court's conclusion would force a taxpayer into a cash basis for all prepaid items and that under Section 42 of the 1939 Code, prepaid sums plainly can be returned in a year other than when received. The court in a strong opinion (at least as a taxpayer's lawyer looks at it) observed that the Tax Court's decision to a large extent would destroy the principle inherent in the accrual method of accounting.

Following *Beacon* came *Andrews v. Commissioner,* 23 TC 1026, involving tuition fees paid in advance. Judge Stephen Rice, writing for the Tax Court, said, "Irrespective of the merits of the generally accepted commercial accounting treatment of prepaid income, it has been clearly established that, under the 'claim of right' doctrine, prepaid income must be reported as income in the year of receipt." Also, "However, accounting practice must bow to established rules of law in the determination of taxable income. The 'claim of right' doctrine is firmly established and must govern the result therein. We agree with the dissenting opinion in *Beacon Publishing Co. v. Commissioner.*"

Then in May, 1955, in *Schuessler v. Commissioner,* 24 TC No. 28, Judge Rice, again speaking for the Tax Court, referred to the fact that the court specifically refused to follow the *Beacon case* in the *Andrews* case and said: "We agree that the principle upon which the *Andrews* case was decided is not in harmony with the generally accepted commercial accounting practices; but on the other hand a contrary result, such as the one reached in the *Beacon* case, does not conform to the firmly established 'claim of right' doctrine governing the receipt of income and its taxability in the year in which received."

The conclusion arrived at by the Tax Court was not surprising — a number of similar cases have been lost by taxpayers — but it was interesting because the Tax Court plainly refused to follow a Court of Appeals decision which had reversed the Tax Court without leaving any doubt as to its position.

This claim-of-right stand seems to have been first taken, unequivocally, in *Moritz v. Commissioner,* 21 TC 622, and there too, interesting to note, it was Judge Rice who wrote the opinion.

The *Scheussler* case was appealed and on March 14, 1956, the Fifth Circuit reversed the Tax Court, in an opinion reported at 230 F.2d 722. The Fifth Circuit stated its view as follows:

"The Tax Court then simply declined to follow the Court in the *Beacon* case, preferring to adhere to its own views as expressed in *Curtis A. Andrews v. Commissioner,* 23 TC 1026. We prefer the reasoning as well as the conclusion reached by the court in the Tenth Circuit. There the opinion correctly, we think, disposed of the 'claim of right' theory advanced by the Commissioner and adopted by the Tax Court in this type of case.

"Finally, we think the enactment ... of Section 462 of the Internal Revenue Code of 1954 and its subsequent repeal constitute no legislative history bearing

on the construction of the provisions of the Internal Revenue Code of 1939."

In the opinion of this writer the Tax Court opinions, if they must stand on the authorities they cite, are not sound. At bottom, they rely on the *North American Consolidated Oil* case, 285 U.S. 417, where Judge Brandeis first laid down the claim-of-right doctrine. But that case dealt with income *actually earned.*

The *Beacon* case, although a real loss to the Commissioner, was not appealed and neither was the *Moritz* or *Andrews* case. Thus, at the moment, we have the Fifth and Tenth Circuits definitely aligned against the position of the Commissioner that the claim-of-right doctrine takes precedence over generally accepted commercial accounting practices. The Tax Court in the *Scheussler* case relied in part on a Fifth Circuit decision, *South Dade Farms, Inc. v. Commissioner,* 138 F.2d 818. The Fifth Circuit in disposing of the *Scheussler* case made no mention of *South Dade Farms, Inc. v. Commissioner.* It seemed a good gamble, before the *Scheussler* decision was handed down, that the Fifth Circuit might affirm the Tax Court and we would have had a conflict which might very well have resulted in the Supreme Court taking certiorari. Now, it would seem that if the Commissioner is going to insist on his position, he will have to look for a case in still another circuit.

The Commissioner has just announced that he will not seek certiorari in *Scheussler.*

The import of all this is that the doctrine of claim of right, which started out as a doctrine to take care of a few factual situations, has now developed into something which may seriously affect accrual-accounting methods.

Do 452, 462 affect prepaid income?

Under this subject the very first problem is the repeal of Sections 452 and 462. Any taxpayer who took advantage of either section had to file a Form 2175 on or before December 15, 1955, and at that time pay the additional tax resulting from the repeal of the sections. For example, if a taxpayer received in 1954 an item of prepaid income, as defined in Section 452, and elected to avail himself of the provisions of the section, that income would have been spread over the period to which it was related and the tax for 1954 computed accordingly.

Now comes the problem. On its face the situation seems clear: a taxpayer elected under the repealed sections to take advantage of them; the sections were repealed and so the advantages accruing under them should be lost. However, the situation is nowhere near that simple. The Senate Finance Committee, in reporting out the repeal sections, admitted this in these words: "Your committee does not, however, believe that the repeal of these sections solves the problem presented."

The instructions to Form 2175 call for the taxpayer to list the items of income deferred and expense deducted under 452 and 462, and they specifically mention subscription income and vacation pay. But both of these are items of which the Finance Committee was unsure and which prompted the above quotation.

Let us take prepaid subscription income first. The committee said of this: "The status of prepaid subscription income will also be uncertain as the result of the repeal of Section 452."

It is uncertain in the committee's view because of IT 3369 and the *Beacon Publishing Co.* case mentioned earlier. IT 3369 permitted deferring subscription income if the publisher had consistently reported on that basis in the past. The *Beacon* case permitted it even if not done in the past, on the basis that it was proper under the accrual method. And, incidentally, the Secretary of the Treasury indicated that the repeal of Section 452 will not be considered as either acceptance or rejection by Congress of the *Beacon* decision and that it would not be taken as an indication of the proper treatment of such an item under prior law or under other provisions of the 1954 Code.

In discussing the *Beacon* case earlier, we were concerned with the claim-of-right doctrine. Let's look at it now in light of the general question of deferring income on an accrual basis. On the general question, although it was a pre-1954 case, the Court of Appeals pointed out that the 1954 Code permits accrual-basis taxpayers to defer reporting advanced payments as income until the year they are earned and assures that items of income and deductions will be properly taken into account. Thus at first glance it would seem that the decision is of little value, at least as to 1954 and later years, because it leaned on sections of law which were repealed. But I think this will turn out to be only a first impression because of what the Senate Finance Committee had to say. In reporting out the repealer of Section 452 and 462 and after discussing the *Beacon* case, the rulings, and *Pacific Grape Products,* 219 F.2d 862 (CA-9), (which belongs for our discussion under accrued expense), the committee said:

"Your committee desires to make its position clear that it expects to report out legislation dealing with prepaid income and reserves for estimated expenses at an early date. As indicated above, the existing rulings of the Treasury Department and the court decisions dealing with estimated expenses and prepaid income are now in such a state of confusion and uncertainty that in the opinion of your committee legislative action is required on these subjects. In addition, your committee believes that it is essential that the income-tax laws be brought into harmony with generally accepted accounting principles."

That sounds much closer to the Tenth Circuit's position than that of the Tax Court in extending the claim-of-right doctrine and raises hopes that ultimately, reporting unearned income will depend not upon possession but upon true income.

To sum up, it would appear that the developments in the deferring of prepaid income are these: The Tax Court is against it, the Fifth and Tenth Circuits are more or less in favor of it, and Congress intends to do something about it legislatively. I think it is fair to conclude that the 1954 Code itself has not changed the pre-1954 situation nor did the repeal of Sections 452 and 462, and the Fifth Circuit in the *Scheussler* case said it did not. It would also seem that business men, accountants, and lawyers will have to continue to claim rights to which they believe they are entitled, as did the taxpayer's accountant in the *Beacon* case.

Problems with accrual of expenses

Accruing expense is a slightly different problem from deferring of income. Taxpayers have done better in accrued-expense cases than in deferred-income cases. Probably this is true because the courts may have found it a bit easier to reconcile business accounting with tax accounting when they are not dealing with an income item actually in possession of the taxpayer. Here, the specific decision mentioned by the Senate Finance Committee was the *Pacific Grape Products* case. In that case, a canner accrued income from sales of goods which were billed but unshipped, and

also accrued shipping costs and brokerage fees in the year in which such goods were ordered. The Commissioner moved the income and expense into the succeeding years and the Tax Court upheld him, with six judges joining in a dissenting opinion. The Court of Appeals reversed the Tax Court, found that the taxpayer's method of accounting clearly and accurately reflected its income, and stated that it agreed with what the six dissenting judges had said. Here is part of the dissenting opinion:

"The practice of disapproving of consistent accounting systems of long standing seems to me to be exceeding all reasonable bounds . . . Methods of keeping records do not spring in glittering perfection from some unchangeable natural law but are devised to aid business men in obtaining intricate accounts. If reasonably adapted to that use they should not be condemned for some abstruse legal reason, but only when they fail to reflect income . . . .

". . . As long as we continue to approve the imposition of theoretical criteria in so purely practical a field, respondent will go on attempting to seize on such recurring fortuitous occasions to increase the revenue, even though he may actually accomplish the opposite . . ."

The judge who wrote that opinion a few months before, and again in a dissenting opinion, made this statement: "It seems to me incongruous to treat the concept of accrual accounting as a rule of law rather than a matter of practical business operation."

The Senate Committee felt that an extension of the principles laid down in the *Pacific* case might lead the courts to permit accrual of most estimated expenses which would have been covered by Section 462. The good business-practice approach was used by the Fourth Circuit in *Harrold v. Commissioner,* 192 F.2d 1002; and in *Central Cuba Sugar Co. v. Commissioner,* 198 F.2d 214, the Second Circuit cited with approval the *Harrold* case. So it would appear that in specific instances the various circuits are beginning to line up in favor of a realistic approach that is in accord with sound business practice. While these cases are encouraging, we should keep in mind that they dealt with facts which probably are not of general interest. In other words, the items involved were not ones which are common to most businesses.

The more common ones, because they were mentioned in the committee reports under the 1954 Code, are sales returns and allowances, quantity discounts, guaranties, and vacation pay. Many taxpayers took advantage of Section 462 and no doubt are now wondering what effect the repeal of the section has on their 1954 and subsequent tax returns. The answer to that question should be in whether or not the item deducted was a proper accrual. Section 462 referred to *reserves* for *estimated* expenses and was limited to allowable deductions, part or all of which would (but for Section 462) be required to be accounted for in a subsequent year. This would seem to mean that if the deduction taken was a proper accrual, neither the passage or repeal of Section 462 should affect the deduction.

Of the common items mentioned in the committee reports one seems most likely to qualify as an accrual rather than a reserve, and that is vacation pay. In addition, it probably is the most common one. And again we find a confused situation. Back in 1947, the Service issued *GCM 25621,* CB 1947-2, 44, recognizing the accrual of vacation pay, payable under a union contract, and in 1949, *IT 3956,* CB 1949-1, 78, again recognized that accrual was proper. The position of the Service apparently was that accrual was proper in the year in which all of the qualifying services were rendered. Then several Tax Court cases came along, all of them denying an accrual, yet all of which were perfectly understandable because of their facts. Following these cases and in accordance with them, the Service issued *Rev. Rul.* 54-608, CB 1954-2, 8, holding that no accrual of vacation pay can take place until the fact of liability to a specific person has been clearly established and the amount of liability to each individual can be computed with reasonable accuracy. It further held that no distinction should be made between written and oral plans, if the plan was communicated to the employee before the beginning of the vacation year and if the rights thereunder are vested. The ruling was to be applied only to years ending on or after June 30, 1955, but in *Rev. Rul.* 55-426, the Service announced that the earlier ruling will be applied only to years ending after December 31, 1955. Finally, by *IRB 1955-52,* 9, the ruling will not apply to years ending prior to July 1, 1956.

So at the present time the situation apparently is this: As to years before 1956, the Service will not object to an accrual under a union contract if the employees have rendered the necessary qualifying service by the end of the taxable period, even if not vested. That is as far as the early rulings went and possibly is as far as the Service will go without an argument. The early rulings did not mention non-union agreements or oral agreements, but if they otherwise meet the Service's new standard, they too should be the basis for proper accruals.

I can see only one fault to find with the present IRS position and that is the vesting requirement. If the payment can be taken away because an employee quits or is discharged with cause, the liability of course has terminated, but it has terminated (1) by reason of an event happening in a subsequent year, and (2) by reason of the act not of the employer but of the person in favor of whom the liability existed. At the end of the period, a liability definitely existed over which the person accruing and deducting it had no control. As to pre-1956 years it may be that the Service will not insist on vesting because the earlier rulings did not require it, but if it does insist, the taxpayer has a basis for litigation. As to post-1955 years, it probably is, in most cases, better business to vest the pay in order to avoid litigation to save the deduction.

Other expenses are also important

Other items which might have been deducted as estimated expenses quite likely are more in the nature of reserves and so under existing law not deductible. There is no intention on my part of slighting these items, but they could be many in character and of little general interest, whereas vacation pay affects almost all businesses. What has been said as to the deductibility of vacation pay will also apply to such of these items which can meet the accrual test. There must be an existing uncontested liability and it must be possible to fix the amount with reasonable accuracy.

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If the items can't meet that test, expect them not to be deductible. The unfortunate thing about that test is that although it sounds simple and clear, courts can and do disagree as to whether a certain set of facts have met it, and about the only comment that can be made is that bad facts may make bad law.

The substance of all this is that the present situation as to accrued expense is very much like that of deferred income. Rough going may be expected in the Tax Court, a more favorable attitude in the Court of Appeals with more circuits in a practical frame of mind and, since the 1954 Code, a better atmosphere in Congress. In fact, you sense a note of impatience in the Senate Committee's report on the repeal of Sections 452 and 462.

Change in method

Frequently it happens that a taxpayer, after running his business for a while, finds that his method of accounting doesn't suit his purposes or his business changes. Or, the Commissioner may determine that the method used does not correctly reflect income. A change in method means more than a change from cash to accrual or accrual to cash, it also includes a change in inventory valuation, a change to one of the long-term-contract methods, from one long-term method to the other, from installment basis to accrual, to or from a reserve method as to bad debts, or a change in the method of depreciation (except a change from declining-balance to straight-line).

When a change is made, adjustment must be made to properly reflect income. The 1954 Code provides that when a change occurs those adjustments must be made which are necessary solely by reason of the change, in order to prevent duplication or omission of income or deductions. *But*, there shall not be taken into account any adjustment in respect of a year to which the new Code does not apply. And here the trouble starts. It is obvious that a taxpayer changing from cash to accrual basis for 1954 might very likely enjoy a definite tax advantage, and this would be equally true if the Commissioner forced a change on a taxpayer. But it must be remembered that the Code provides that before changing, a taxpayer shall secure the consent of the Commissioner. Thus it would seem that the only taxpayers who would obtain this advantage would be those who filed a timely application or those whom the Commissioner changed, and it is unlikely that there would be many of these for 1954. There are neither Regulations or rulings to guide us on this question yet, but there would seem to be no reason to expect that the Commissioner would relax his position in new Regulations so as to permit later filing of an application to change. Thus any tax advantage under this section, except for those who actually obtained consent, can come only through litigation and can result only in those cases where a taxpayer has made a change without permission. The change might be an out-and-out change, or it might only be a change in treatment of one or more items to conform to an existing method. In other words, it might be either a change or a correction. I believe there is basis for litigation because I feel that Section 446 needs up-to-date judicial construction.

Section 446 provides, first, a general rule that taxable income shall be computed under the method by which the taxpayer regularly computes his income in keeping his books. Then it provides this exception:

". . . If the method used does not clearly reflect income, the computation shall be made under such method as, in the opinion of the secretary, or his delegate, does clearly reflect income."

Then, always subject to these provisions, a taxpayer may use one of the accepted methods of accounting. Finally, comes the provision requiring consent of the Commissioner to a change. I cannot reconcile this last provision when I remember the basic requirement of the section, that the method used must clearly reflect income, unless permission is only required where either of two methods will clearly reflect income. In other words, I don't see how the Commissioner can possibly have authority to permit a change to a method which doesn't clearly reflect income, or on the other hand how a taxpayer using such a method would have any legal basis for continuing it with or without permission.

To conclude, I can't stress too strongly my feeling that in handling a prepaid-income or deferred expense problem, bad facts may very well make bad law for you and, before deciding on a course, you must look over your facts with a very critical eye. ☆

Can corporation deduct, officer escape tax on, salary paid in common stock?

DID YOU THINK the *Daggitt* case (23 TC 31 (1954)), which held the officer-stockholders not taxable on salary paid in common stock, too good to be true? Though the IRS has acquiesced, the case itself has been criticized as ill-considered. The *Yale Law Journal* carried a note (Vol. 64, p. 929) which analyzed carefully the rationale of the case and its implications for stockholder-operated companies. The note said (in part):

Background: Eisner v. Macomber

A frequently-employed method of payment of salary to officer-stockholders transfers to the employee shares of stock in the corporation. The recipient must report as gross income the fair market value of the stock at the date of transfer. A cash-basis employee reports income in the year of transfer, while an accrual-basis employee reports income in the year when his salary claim against the corporation accrues.

Under the rule of *Eisner v. Macomber* [252 U.S. 189 (1920)], a stockholder receiving a distribution of shares of stock in proportion to his holdings in the corporation realizes no taxable income within the meaning of the Sixteenth Amendment. Such a stock dividend, involving a transfer of corporate funds from undistributed surplus to capital, does not result in a severance of income from the capital assets of the corporation. And since it does not change the stockholder's "proportionate interest" in the corporation, it does not increase the intrinsic value of his holdings. Under the proportionate interest test stock distributions are taxable if they give the recipients a different interest in the corporation in terms of dividend, voting, or liquidation rights. But it is clear that no income is realized in cases like *Eisner v. Macomber* involving distributions of

common stock pro rata to existing holders of common stock.

The Daggitt case

The recent case of *Deloss E. Daggitt* presented a unique situation in which stockholders received a pro rata distribution of stock as payment for services rendered to the corporation. The case arose under the 1939 Code. The effect of changes in the 1954 Code is discussed below. Producers Transport, Inc., accrued in December 1947, a $10,000 salary liability for services performed in that year by its two principal stockholders, and deducted the expense from its 1947 income-tax return. Of this amount, $9,000 constituted the 1947 salary of Daggitt, the president of the corporation, and $1,000 constituted additional compensation to Reid, its terminal manager. At the time these salaries were voted, the stockholders agreed to accept payment in stock of the corporation. In February 1948, Producers Transport settled the above liability account by authorizing and issuing to the employee-stockholders at par value 1,000 additional shares of $10 par common stock. Daggitt, holder of 90.84 per cent of the existing common stock, received 900 shares, while Reid, holder of 9.08 per cent, received 100 shares. The corporation debited the salaries payable account and credited the capital account, but did not capitalize surplus. Daggitt, deeming himself to be on the accrual basis, reported his salary as part of his gross income for 1947. Reid, a cash-basis taxpayer, reported his additional compensation as income in 1948.

Essentially a stock dividend

The Commissioner determined deficiencies in the 1948 returns of both employees, contending that upon receipt of the stock Daggitt and Reid had realized income to the extent of the fair market value of the stock—$58.75 per share, $52,875 for Daggitt, $5,875 for Reid. The deficiencies were due to the fact that the market value was almost six times the par, the figure used on the books in satisfying the salary liability. The Tax Court held that the employees had received no constitutional income, since their "proportionate interests" in the corporation were "substantially" maintained by the stock distribution. Although it stated that the distribution was not a stock dividend, presumably because there had been no capitalization of surplus, the court found that *Daggitt* presented a situation "so close" to *Eisner v. Macomber* that it felt compelled to follow that case.

The Tax Court could have reasoned that the stockholders constructively received payment in cash of their salary claims, and simultaneously subscribed pro rata for the equivalent par value of additional stock in the corporation. Daggitt and Reid *considered* that they had received income, since they reported their salary claims. And *Daggitt* presented no problem of tax avoidance, since the salaries deducted by the corporation were included by its stockholders. If the proportionate interests of the stockholders had changed as a result of the salary accrual and stock distribution, the stockholders would have been taxable to the extent of the fair market value of the stock distributed. But since the stockholders' interests in *Daggitt* remained unchanged, *Eisner v. Macomber* would prevent their realization of any income except the salary constructively received. The Tax Court, however, held that *Eisner v. Macomber* prevented realization of *any* income, even though the stock was distributed in payment of accrued salaries rather than as a dividend.

Exemptions under 1954 Code

Section 305(a) of the Internal Revenue Code of 1954 grants tax exemption to "any distribution made by a corporation to its shareholders, with respect to the stock of such corporation," in stock of the corporation, even when this disturbs the proportional interest of existing shareholders. Since the phrase "with respect to the stock of such corporation" was intended to make clear that this section exempted any distribution to stockholders by reason of their rights as "holders" of existing stock, it may mean that the section does not exempt a pro rata distribution to employees for accrued salaries. Moreover, where a stock distribution "has the effect of the payment of compensation" for services rendered to the corporation, Section 305(c)(3) refers to Section 61(a)(1), which includes such compensation within gross income. Although this cross reference has no legislative history and is intended to have no legal effect, it suggests a continuing congressional intent to tax stock distributions received as compensation. Congress apparently did not consider in 305(c)(3) the effect of *pro rata* stock distributions to employees. But under the Tax Court's theory, *Eisner v. Macomber* would impose a constitutional prohibition against taxing these distributions, despite any attempt in the 1954 Code to subject them to taxation.

Tax advantage to corporation?

The Tax Court holding that the stockholder-employees in *Daggitt* received no taxable income indicates the possibility of substantial tax advantages for corporations which consider their stockholders as employees for the purpose of salary deductions but as investors for the purpose of stock distributions. Producers Transport eliminated the $10,000 liability for accrued salaries by means of its stock distribution in 1948 without any diminution of assets. It still retained full control of the amount which it added to its capital account. Yet the corporation's taxable income for 1947 was reduced by the amount of the deduction for accrued salaries payable, thereby resulting in a tax saving of approximately $5,700. And under the Tax Court holding, cash-basis employees would not be obligated to report the salaries or stock distribution as income. Therefore a tax advantage is inherent under *Daggitt* unless the Commissioner can either disallow the corporation's salary deduction or find a realization of income by the corporation when the liability for salaries is eliminated by the stock distribution.

Controlling and noncontrolling stockholders

The principal weapon to prevent the salary deduction is Section 24(c) of the 1939 Code, now Section 267(a)(2) of the 1954 Code. This section prohibits a corporation from deducting expenses, including salaries, accrued to a stockholder who directly or indirectly owns more than fifty per cent in value of the stock of the corporation, if these expenses are not "paid" during the corporation's taxable year or 2½ months thereafter, and if they are not "includible" within the same period in the gross income of the stockholder.

If the ninety per cent stockholder in *Daggitt* had been on the cash basis, the pro rata stock distribution would never have been includible in his gross income, because it did not constitute income. Therefore the salary would be deductible only if the stock distribution constituted payment. The cases construing Section 24(c) have indicated that a liability is not "paid" by a debtor corporation unless it produces taxable income

to the creditor. Any other interpretation would contravene the policy of 24(c): to produce uniformity among related taxpayers, by preventing a corporate deduction without an accompanying inclusion of the same amount by the controlling stockholder. It therefore seems clear that corporate distribution of stock pro rata will not permit a salary deduction under 24(c).

Section 24(c), however, is wholly inapplicable to a person, such as Reid, owning fifty per cent or less of the corporate stock, even though as a cash-basis taxpayer he may never report his salary as income. Moreover, the policy of the section is satisfied in the case of an accrual-basis stockholder, such as Daggitt, since the salary deducted by the corporation is includible within his gross income regardless of whether he receives payment. In both situations, the corporation can deduct reasonable compensation for stockholders.

There would be no tax advantages if the corporation were held to realize income upon elimination of the salary liability. When a debt is settled for less than its face value, the debtor normally must report as taxable income the difference between the amount of the obligation and the amount of the settlement. But a discharge of indebtedness may be considered as a gift and not taxable to the debtor if the intent of the creditor was to forgive all or part of the claim without consideration, rather than to get the "best price available" from the debtor.

A Treasury Regulation provides that when a shareholder in a corporation which is indebted to him "gratuitously forgives the debt" the transaction usually results in a "contribution to the capital of the corporation to the extent of the principal of the debt." Although this might imply that forgiveness of a *non*-principal indebtedness produces income to the corporation, some courts have interpreted the regulation to mean that a stockholder's gratuitous cancellation of any corporate debt owed him, including accrued salaries and interest, results in no income. But the Eighth Circuit, in *Helvering v. Jane Holding Corp.* [109 F.2d 933 (8th Cir.), *cert. den.* 310 U.S. (1940)], noting the prior saving by the corporation when these expenses were deducted, considered the Regulation applicable only to the forgiveness of "principal" indebtedness such as loans to the corporation, where there had been no previous tax benefit. It held that the discharge by the sole stockholder of a claim for accrued interest on a loan resulted in income to the corporation.

"Principal" as used in the regulation apparently refers to the principal amount of a debt, as differentiated from interest, and does not seem to distinguish between a deductible expense and other debts. However, the tax benefit to the corporation from the deduction of the principal amount of a debt for salary is identical to that resulting from deduction of interest. Therefore the cases extending the *Jane* rationale to a stockholder's forgiveness of a salary claim seem justified.

Despite the possible limiting effect of the Regulation, forgiveness of even a salary claim may not produce income to the corporation if a stockholder's intent in fact is to make a gift. Donative intent might seem particularly clear in a case such as *Daggitt* where the controlling stockholders received no consideration for cancellation of their salary claims, since, under the Tax Court reasoning, the stock distribution did not result in any income to them. Yet where all the shareholders of a corporation participate in a proportionate forgiveness of these accrued corporate liabilities, it seems unreasonable to conclude that they are making gifts, because the "forgiveness" merely increases the value of their proportionate interests in their own corporation. Even if the controlled corporation is regarded as an entity distinct from its stockholders, both the tax benefit resulting from the prior deduction of the salary claims and the improved capital position of the corporation resulting from the debt cancellation provide sufficient consideration for the forgiveness. Proportionate forgiveness of accrued salaries should therefore result in income to the corporation to the extent of the deduction previously taken in the year of salary accrual. ☆

New accounting decisions this month

CAPITAL GAINS & LOSSES

Gross income includes full long-term capital gains. Capital gains must be included in full in gross income in determining whether under Section 130 of the 1939 Code the deductions attributable to a trade or business carried on by an individual for five consecutive taxable years have, in each of such years, exceeded by more than $50,000 the gross income derived from such trade or business. *Rev. Rul.* 56-191.

Payments by sublicensees of ice-cream mix are royalties. Taxpayer-corporation had acquired from its stockholders the rights and franchise for the manufacture in Oklahoma of a patented ice-cream mix. It also owned patented freezers used to manufacture and dispense the mix under a restriction not to remove or use such machines outside the state. Taxpayer entered into 36 subfranchise agreements with "licensees" who were given an exclusive territory within the state. The "licensees" were to pay a lump sum plus 35 cents a gallon for each gallon of mix used in the freezers which were to "remain the property of" taxpayer. The court finds the agreements were licenses and the payments, both lump-sum and gallonage, royalties and not capital gain. There were too many restrictions on the user to treat the arrangement as a sale. Since more than 80% of the reported gross income was "royalties," which is personal-holding-company income, taxpayer was classified as a personal holding company for 1948. *Dairy Queen of Oklahoma, Inc.*, 26 TC No. 5.

Tax Court reversed; rental houses were not held for sale. Within two years, taxpayer sold all the houses constructed for rental under FHA regulations. The Tax Court held that even if they had been erected originally as an investment, they were held for sale in the two years involved. This court reverses. If there is a genuine intent to liquidate, the methods used and frequency of sale are irrelevant; liquidation is not carrying on a business. Here the sales were to tenants exercising their option to buy, at a low price. The houses were not held for sale, they were held for rent. Gain on sale is capital. *Smith*, CA-5, 4/6/56.

Disposition of subdivided parcels constitutes a business; Sales reportable upon collection. The disposition by taxpayer with a degree of frequency and continuity of parcels subdivided and developed from an inherited tract was held under the facts to constitute the carrying on of a trade or business, so that the

parcels could not be treated as capital assets. Income from sales executed at the end of 1949 were held properly reportable on the cash basis in 1950; only a small deposit was made in 1949 and the balance of the price plus delivery of the deed were made in 1950. *Yunker*, 26 TC No. 17.

Farmer in the buiness of selling improved lots of real estate. A farmer who had purchased undeveloped property some time back, plotted, subdivided, and improved the property for sales through a real estate broker. He sold 85 lots in 1946, 68 in 1947, and 69 in 1948. The court holds the gain in 1947 was taxable as ordinary income since the sales were numerous, frequent, and continuous, not merely isolated or casual. *Winston, Jr.*, TCM 1956-91.

No capital gain on sale of lots from inherited tract. Taxpayer inherited a tract of land. She entered into an agreement with a brokerage firm to subdivide the property, clear and gravel streets, and sell the lots for 5% commission plus 50% of the profits. Gains from the sale of the lots were held to be ordinary income; she was a participant with the brokers in a going business. *Briggs*, TCM 1956-86.

Jury finds capital gain on real estate sold by brokers. In a jury trial, the judge charged that the fact that taxpayers were engaged in the real-estate-brokerage business did not mean that they could not simultaneously hold real property for investment. However, the burden was on taxpayers to show that the character of their holding had changed, since in a prior year the property had been held primarily for sale. The jury finds that the property was not held primarily for sale in the year of sale. *Ryman*, DC Fla., 5/1/56.

Ordinary income on repayment of business debt in devalued currency. Taxpayer purchased burlap from India in 1944 for use in the ordinary course of business. The purchases were payable in English pounds sterling. It entered as the cost of the goods and its liability the dollar amount at $4.04. Prior to payment the pound was devalued. The dollar cost of pounds to pay the debt was substantially below the liability per books. This, the court holds, was taxable as ordinary income rather than capital gain. The foreign-exchange transaction was an integral part of taxpayer's ordinary business dealings. *American-Southeast Asia Co., Inc.*, 26 TC No. 21; *Bevmore Corp.*, TCM 1956-101.

Sale of short-sale contract didn't convert gain from short to long term. In July and August, 1949, taxpayer sold short English pounds sterling for delivery seven months later. As he expected, the pound was devalued in this period and he made a substantial profit. Immediately prior to the closing dates taxpayer "sold" the contract rights to his broker, who made the "purchase" as an accommodation at no profit to itself. Taxpayer claimed a long-term capital gain on sale of the contracts. The court ruled that the broker acted only as taxpayer's agent in closing the short sale, rather than as purchaser of the contracts, since taxpayer remained fully liable until the short sales were finally consummated. Inasmuch as taxpayer himself was held to have closed the short sale, and because the holding period of the pounds sterling with which such sales were closed out was less than 6 months, he had short-term capital gain. *La Grange*, 26 TC No. 20.

Capital gain on sale of breeding cows. Profits from certain sales of cows ranging from 3 to 12 years of age which had been raised by taxpayer were held to result in capital gain. Without reviewing the evidence in detail, the court says merely that the animals involved were part of the breeding herd and were not held primarily for sale to customers. *Daughtry Estate*, TCM 1956-105.

Capital gain for auto dealer on company cars. Taxpayer, an auto dealer, had some thirty cars it used to pick up customers, transport officers, etc. It claimed depreciation on them and capital gain on the sale of 16 of them. The court allows this treatment. The Commissioner claimed that since the cars were sold for approximately the new-car price, they were held for resale. The court based its holding on the fact that the cars were used in the business, these thirty cars were held for both purposes but in view of the total sales (over 2,000) the intent to use them was primary. *W. R. Stephens Co.*, DC Minn., 4/13/56.

Investor not in business; has capital gain (old law). An assignment of a patented continuous-coal-mining machine by taxpayer, its inventor, to a manufacturer is held to be an outright sale of a capital asset resulting in long-term capital gain. The fact that taxpayer had reduced to practice four basic inventions in over 25 years and had sold one other invention did not put taxpayer in the business of making and marketing inventions. [Section 1235 of the 1954 Code specifically provides that an inventor realizes capital gain whether or not he is in the business of inventing. *Ed.*] *Silver*, TCM 1956-95.

Inventor gets capital gain on sale and ordinary income for promoting device. Taxpayer in 1944 assigned to Baldwin Locomotive the exclusive right to manufacture, use, and sell his patented invention, agreeing to be available for consultations, in return for 5% of sales. He also contracted to promote and develop business for the invention for an additional 2% of sales. Payments of the 5% are held to be for the outright sale of the invention taxable as capital gain, while the 2% payments were taxable as ordinary income. *Ruge*, 26 TC No. 14.

NEW CASES INVOLVING DEPRECIATION & DEPLETION

Transferee in tax-free reorganization not bound by predecessor's accounting method. [*Non-acquiesence*] Taxpayer was created and acquired railroad properties in a tax-free reorganization. Its predecessor had used the retirement method of accounting. The taxpayer computed depreciation on straight-line method on the predecessor's basis — essentially the original cost of the properties. The Tax Court sustained the right of the taxpayer as a new corporation to elect straight-line depreciation and also to use the predecessor's basis without the adjustment proposed by the Commissioner to reflect depreciation from 3/1/13 to the date of the tax-free reorganization. *Akron, Canton & Youngstown Ry. Co.*, 22 TC 684, *non-acq.* IRB 1956-18.

Court of Claims again holds amortization can't be limited to fraction of cost. Following its decision in *Wickes*, 123 Ct. Cls. 741, *cert. denied* 350 *U. S.* 862, and *Ohio Power*, 131 Ct. Cls. 95, the court again holds that a taxpayer is entitled to rapid amortization of the entire cost of emergency facilities even though the certificate was limited to only

part of the cost. *Allen-Bradley Co.*, Ct. Cls. 4/3/56.

Part of corporate entertainment expense held dividends to sole stockholder. Taxpayer was president and sole stockholder of Welcome Wagon, Inc., which owned and operated a houseboat he used for entertaining. The Tax Court allowed 50% of the costs as an expense of the corporation. The other 50% is found to be a taxable dividend to taxpayer. *Briggs*, TCM 1956-86.

ACCOUNTING METHODS

Uncollected accounts become income on voluntary change to accrual basis. In 1950 a painting contractor changed the character of his business to include a drapery, furniture, and slipcover department. At the same time he changed from the cash to the accrual method of accounting without prior consent. The court required him to include in his 1950 income the uncollected accounts receivable of prior years which in the absence of such adjustment would have entirely escaped taxation. *Walker*, TCM 1956-110.

Tax Court must consider evidence of allocation of price for group of assets. Taxpayers sold all its assets at a price in excess of basis. It was agreed that the profit did not attach to assets other than inventory and capital assets. The Commissioner allocated the gain in the same proportion as book value, and the Tax Court agreed. This court finds that taxpayer's evidence of the intent of the parties overcame the presumption that Commissioner's mechanical formula was correct. Case reversed and remanded. [Gain on inventory would be ordinary. *Ed.*] *Bryant Heater Co.*, CA-6, 4/14/56.

Partners sell installment receivables to their new corporation; held a taxable realization. Taxpayer was one of two partners in a building firm. With a third person the two partners formed a corporation and the partnership sold all its assets to it for $100,000 cash and its note (about $300,000). Included in the assets sold were installment receivables for homes sold on which the unrealized profit (the partnership reported on the installment basis) was about $200,000. Taxpayer reported capital gain on his share of the proceeds of sale of partnership assets. The Tax Court held, and this court agrees, that $200,000 of the proceeds must be treated as realization of the deferred profit on the installment notes. That is ordinary income. *Krist*, CA-7, 3/20/56.

DEDUCTIBILITY

Track can't deduct campaign for votes for dog racing. Taxpayer expended a sum to aid in persuading voters to approve licensing of dog racing and claimed the payment as a business expense. Finding that the question of "ordinary and necessary" is one of fact, the court affirms the lower court disallowance. The court distinguishes an expense of doing business from one of trying to get new business, and finds the latter not ordinary and necessary. Further, the payment may have been prohibited by public policy. Finally, under the Treasury Regulations, expenditures made to promote or influence legislation are not deductible. *Revere Racing Association*, CA-1, 5/9/56.

Money given to confidence man to bet on "fixed" races is "stolen" and therefore deductible. Taxpayer paid large sums of money to a confidence man based on his fraudulent representations that he was the son of Ben Jones, the Calumet stables trainer, and that such sums would be bet for him on fixed horse races. The district court held that since the losses were thefts under local law they were deductible. This court affirms. There is no merit to the argument that public policy prevents the deduction, since taxpayer was party to an illegal scheme. *Bromberg*, CA-5, 4/12/56.

Legal expenses of illegal business deductible. Taxpayer operated illegally as a bookmaker in Illinois. The Tax Court allowed him to deduct wages and rents, and this court affirms. The Commissioner argued that under Illinois law the landlord and the employees were accessories. However, they are also ordinary and necessary to the business and in the absence of a specific provision in the law must be allowed. One dissent: being for an illegal business, the expenses cannot be necessary. *Doyle*, CA-7, 4/11/56.

Intangible drilling costs not included in "five-year" loss. Intangible drilling and development costs in the case of oil and gas wells are to be disregarded in determining under Section 270 whether the deductions of the taxpayer attributable to a trade or business carried on by him for five consecutive taxable years have, in each of such years, exceeded the gross income by more than $50,000. Section 270 limits deductions for losses in such a business to $50,000 but the statute specifically excludes expenditures which taxpayer has the prior option to deduct or capitalize. *Rev. Rul.* 56-170.

Can deduct cost of settling suit re OPA violations. Payments made in settlement of a suit alleging violation of the Defense Production Act of 1950 are deductible from gross income if the payments are not certified for disallowance to the IRS by the Economic Stabilization Agency or its authorized components. *Rev. Rul.* 56-180.

Deduction denied for life insurance premiums paid to protect investments. Taxpayer purchased contingent remainder interests as an investment. Since he would get nothing if the remaindermen did not survive the life tenants, he took out insurance policies on the lives of the remaindermen solely as a protection for his investment. Deduction of the premiums paid was disallowed by the Tax Court as a business expense inasmuch as the insurance proceeds, when paid by reason of death, will consitute tax-exempt income. This court affirms. The cases allowing a creditor to deduct premiums on insurance on debtor's life involve the protection of collateral securing the debt. There is no debt here. *Jones*, CA-3, 4/6/56.

Venezuelan firm is corporation; as stockholders, owners can't take depletion. Taxpayer held certificates of ownership in two Venezuelan entities, called "Compania Anonomia," which collected oil royalties, paid expenses, and distributed the remainder to the owners. Taxpayer argued that the Venezuelan entity should be disregarded and depletion and credit for foreign taxes paid allowed them. The Tax Court held that the Venezuelan entity could not be ignored. This court affirms. *Buckley*, CA-2, 3/29/56.

Officer-stockholder can't deduct corporate expenses as his business expenses. Taxpayer, an officer-stockholder of two corporations which lacked cash to meet current expenses, paid certain current operating expenses to keep the corporations alive and thereby avoid personal liability which might otherwise be im-

posed upon him as a stockholder and surety or guarantor of alcohol taxes. The payments were additional cost of his stock; they can not be deducted by taxpayer as an ordinary and necessary business expense. *Ihrig,* 26 TC No. 6.

Costs under general plan of permanent betterment must be capitalized. A physiotherapist purchased three old residences for use in his practice. Two of the buildings required over-all general rehabilitation, remodeling, and improvements. Such alterations and all repairs were held to be incidental to a general plan for permanent betterment which materially added to the value of the buildings. Accordingly none of the expenditures was deductible as a current expense. However, part of the costs in rehabilitating the third building, which was already being used as a clinic when acquired, was held deductible as a repair to keep the building in ordinarily efficient operating condition. *Allen,* TCM 1956-88.

Must deduct tax when paid despite suit for refund. [*Certiorari denied*] In 1938 and 1939, taxpayer paid New York City real-estate taxes under protest that the assessments were too high; it made the payments to avoid penalties and imposition of liens. In 1941, after litigation, it received part of the refund it claimed. The taxpayer contended that the 1938 and 1939 accruals should be limited to the amount of liability it admitted in its protests for those years, with the balance accruable in 1941. The court holds that the entire tax was deductible when paid; the refunds are income in 1941. Though the *Dixie Pine Products* case (320 U.S. 516) denied deductibility of a disputed tax, it does not control. There, the disputed liability was not actually paid. The court followed its own rule in *Chestnut Securities. Dixie Pine* denied a deduction for an expense which might never be incurred. Here the tax had undoubtedly been incurred. *Consolidated Edison Co. of New York, cert. den.* 4/23/56.

Broker, taking over customer's account at more than market, has no loss while it holds securities. The taxpayer's customer was obligated to buy securities when issued, at a price about $123,000 more than current market. The taxpayer took over these buy contracts, releasing the customer, in exchange for the customer's collateral of about $63,000. The Tax Court held that the whole transaction was not closed; taxpayer did not sell and take a loss and establish a claim against the customer. It stayed at the risk of the market, and, in fact, ultimately realized a profit on the deal as a whole. *Loewi & Co.,* CA-7, 4/16/56.

Rent under lease with option to purchase deductible; taxpayer acquired no equity. Taxpayer rented property from the RFC, with option to purchase at reducing price. The court finds that the total rent was not equal to the value of the property; that the option price was substantial. It was the intent of both parties to enter into a lease, not a sale. Taxpayer was not obligated to exercise the option; the rental payments were reasonable and were not to be applied on the purchase price. Accordingly, the claimed rental deduction is allowable. The Tax Court is reversed. *Breece Veneer and Panel Co.,* CA-7, 4/26/56.

Landlord has no loss when tenant under 25-year lease demolishes building with shorter remaining life. Taxpayer claimed a loss of the unrecovered cost of a building when it was demolished (as provided for in the lease) by the tenant. The lease was for 25 years, and the building had an expected remaining life of 16 years. The Tax Court said that in view of these time factors, taxpayer had no loss on demolition. This court affirms. *Blumenfeld Enterprises,* CA-9, 4/13/56.

BAD DEBTS

Advances by Tony Martin to complete production of Casbah a business debt. [*Acquiescence*] Tony Martin, while in the army, received some unfavorable publicity. Upon his return to Hollywood his agent decided to star him in an independent production, *Casbah,* to re-establish him. A corporation was organized with the help of outsiders, but to complete the financing of the picture Martin was forced to advance large sums to the corporation. The picture was a dud and the loans became worthless. The court held that although the investment in the corporation was not a normal part of Tony Martin's business activity as an entertainer, the additional advances to complete the picture, which had been undertaken in the first instance to re-establish him in the motion picture industry and thereby save his career, were in connection with his business. Martin was permitted to deduct the worthless loans in full in the year of loss as a business bad debt. *Martin,* 25 TC No. 15, *acq.* IRB 1956-18.

Debts not worthless; debtor's assets exceeded liabilities. In 1947 taxpayer made loans to the corporation of which he was stockholder and officer. The advances were repaid in full in 1948, however taxpayer sought a bad debt deduction for 1947. The District Court denied it; at the end of 1947 the assets of the corporation exceeded its liabilities. This court affirms. *Bratton,* CA-6, 3/2/56.

Year of worthlessness not proven; bad debt denied. Taxpayer failed to prove that mortgage notes which he held became worthless in the years claimed. From the record the court concluded that most if not all the notes were worthless long before then. *Reger,* TCM 1956-89.

No bad debt for theft of notes. Notes receivable arising out of taxpayer's business were stolen. Taxpayer claimed, in the alternative, a theft loss in the year of the theft, bad debts in the year of the theft, or bad debts in the subsequent year. The court holds that since the makers of the notes were not shown to have been insolvent, and since taxpayer made no effort to collect the debts, the debts were not proved worthless in either year. Further, taxpayer's failure to give himself credit for these notes when he created a family partnership in the year following the theft does not give rise to a bad-debt loss. Finally, since the theft of the notes did not extinguish the underlying debt, there was no theft loss. *Perry,* DC Ga., 3/2/56.

WHAT IS INCOME

Municipal certificates are state obligations though paid off by special assessments. Interest received on certificates issued by a municipality to a contractor as payment for paving certain streets and alleys is tax-exempt even though payments on the certificates are made from special assessments levied against the benefited property owners. *Rev. Rul.* 56-159.

Free installations deductible as advertising but taxable to recipient. A manufacturer of louvered windows, awnings, etc. who installed and demonstrated its

products free of charge in private homes as part of an advertising campaign can deduct as business expenses all the costs incurred including payments for damages during installations. The homeowners must report in income the difference between the value of the new products and the replaced ones. *Rev. Rul.* 56-181.

Indian not taxable on gain on sale of lands in trust. Under treaty, certain tribal lands are held in trust for emancipated members of the tribe. Taxpayers paid capital-gains tax on land sold by the trust, but sued for refund. CA-9 upheld the District Court finding that the gain is not taxable. It commented, "In our view, this attempt to tax evidences, at the least, a sorry breach of faith with these Indians." The Supreme Court affirms. *Capoeman,* Sp. Ct., 4/23/56.

Tax savings, due to transfer, paid to transferor, are income. Taxpayer-bank, in receivership, transferred its net assets, including real estate, to new bank. For purpose of assessing bank stockholders under Louisiana state law, the value of real estate is deductible. The new bank turned over to taxpayer the "savings" resulting from the real-estate credit over the years of liquidation and litigation. The court holds that these savings, though neither business income nor any other type specified in 1939 Code Section 22(a), fall under the all-inclusive clause "gains or profits derived from any source whatever." *Commercial National Bank of Shreveport,* DC La., April 1956.

Salary is business income for the net operating loss. In determining the net operating loss, nonbusiness deductions of an individual are allowed only to the extent of nonbusiness income. (The final loss figure on the return is reduced by the excessive nonbusiness deductions to get the loss which can be carried over.) The court holds that taxpayer's salary is business income. The effect of this is to make the excess of nonbusiness expenses over nonbusiness income greater and reduce the allowable operating loss. *Wile,* TCM 1956-90.

BASIS QUESTIONS

Value of land acquired by gift and inheritance determined. Taxpayer sold land acquired partially by gift in 1923 and partially by inheritance in 1932. For basis purposes, the court determined the March 1, 1913 value of the gift portion, the donor having acquired it prior thereto, and decided also that the basis of the remaining portion should be its 1932 valuation for estate-tax purposes, holding that such valuation had included only the land and not also dwelling. *Saegmuller,* DC Va., 2/15/56.

Transaction previously treated as sale may not later be termed gift. In 1929 taxpayer-corporation purchased stock from the father of its principal stockholders, the seller claiming a deduction for a loss on the sale. The Commissioner had attacked the bona fides of the transactions and had disallowed part of the loss then claimed. [Under the 1954 Code this loss on the sale, being between related parties, would be disallowed under Section 267(a). *Ed.*] Taxpayer later exchanged this stock for stock in another corporation in a tax-free exchange. On the sale of the latter stock, taxpayer claimed that the original stock had been received by gift rather than by purchase. This would give a higher basis for the stock being sold. The court requires consistency of treatment of the transaction in which the stock was first acquired. While the Commissioner may look through form to substance, the same choice does not lie with the taxpayer, who may not disregard a deliberately chosen arrangement for conducting his affairs. In any event, taxpayer failed to prove that the alleged donor's basis was higher than the basis allowed by the Commissioner. *Interlochen Co., Inc.,* CA-4, 4/24/56.

Developer can't charge temporary water supply system to cost of lots. In order to develop and subdivide a tract of land, taxpayer acquired a water-supply-pumping system which it owned and operated at a loss to supply water to the houses in the development. It intended to abandon the system once a water utility came into the area. The court holds the cost of the system was not a development expense and could not be added to the cost of the subdivision lots to determine the gain on the sale of such lots. The fact that it retained ownership of the pumping station distinguishes this case from those allowing land for streets and parks to be treated as costs of lots sold. *Colony, Inc.,* 26 TC No. 3.

WHOSE INCOME IS IT

Seller of stock taxable on dividend though applied against purchase price. Taxpayer on July 29, 1950 agreed to sell his stock in a controlled corporation to two buyers for $45,500. The buyers made a down payment of $2,000 and reassigned the stock to the seller as collateral security for the payment of the balance of the price in installments. A dividend declared on July 29th and payable to stockholders of record on July 28th was held taxable as ordinary income to the seller, even though the agreement of sale provided that the dividend would be applied against the purchase price, since the seller owned the stock on the declaration and record dates. *Miller,* 26 TC No. 16.

Buyer taxable on dividends on stock in trust to secure payment. Taxpayer purchased stock but it was held in trust, and dividends paid on it were applied as payments against the principal and interest of his promissory note for the purchase price. These dividends are ordinary income to the purchaser. The seller may treat the stock sold as a capital asset and the sale may qualify as an installment sale if the requirements as to sales price and initial payments are met. *Rev. Rul.* 56-153.

Assignment to wife of right to receive royalties upheld; she is taxable on income. Taxpayer sold an invention to a company on a royalty basis. After receiving royalties for several years he irrevocably assigned to his wife all his rights in future royalty payments, paying a gift tax on the transfer. The Commissioner claimed that this was a mere assignment of income and that taxpayer remained taxable on it. Affirming the Tax Court, this court holds the assignment to be effective for tax purposes, for the following reasons: (1) this was a genuine transfer, deserving the same treatment given transactions outside the family group; (2) the right to receive future payments was an assignable property right; (3) by the gift, taxpayer lost all command over the future payments; (4) the treatment should be consistent with the tax result if taxpayer had first assigned the invention to his wife; on a subsequent sale by her no issue would have been raised concerning taxability of the royalties to her; and (5) this is not a case of taxation of

compensation to the one who earned it since taxpayer was never employed by the company. The following leading cases are distinguished: *Helvering v. Eubank* and *Lucas v. Earl*—this was not an assignment of compensation for services; *Harrison v. Schaffner* and *Helvering v. Horst*—this was not an attempt to keep the "tree" and assign the "fruits;" *Helvering v. Clifford*—the assignor here did not remain in substance the owner of the income-producing property. *Reece*, CA-1, 5/3/56.

Winery income taxable to individual managers, not to their corporation; they didn't assign their interests to it. Taxpayer's father owned a winery which he was willing to sell to taxpayer and one Kershaw when they secured the necessary federal and state permits. Pending receipt of such permits, they agreed in an executory contract of sale to operate the winery for the father beginning 1/1/46 in return for the earnings during the period of their management. The basic permits were not issued until August 1946, and although taxpayer and Kershaw organized a new corporation in March 1946 to take over the winery, there was no assignment to the corporation of their interest in the sales agreement. The court holds that the earnings from the sales of wine during the months March through June 1946 were not taxable to the corporation, since the corporation never had title to the wine inventory; the earnings were taxable in equal amounts to the taxpayer and Kershaw as compensation for their management services. *Azevedo*, TCM 1956-109.

No constructive receipt on extension of certificates' maturity date. A holder of an accumulated installment certificate issued by Investors Syndicate who elects prior to maturity to receive the matured value of the installments over a period of years is not in constructive receipt of the face value on the maturity date, and is not taxable upon any amount until he has first recovered his cost. Similarly, where the holder elects prior to maturity to extend the original maturity date of a face amount certificate, he is not in constructive receipt of income in the year such certificate would have originally matured. *Rev. Rul.* 56-77.

Construction company not taxable on profit paid to affiliated foundation. [*Acquiescence.*] Taxpayer was a heavy construction company. Being unable to secure the necessary performance bonds or to borrow from usual sources, it borrowed $75,000 from a foundation created some five years before by the family of the owners of 2/3 of taxpayer's stock. For the loan the foundation was to secure 50% of the profit on the job; this amounted to about $34,000 in one year and $87,000 in the second. These amounts the Commissioner determined to be taxable to the taxpayer. The Tax Court disagrees; the loan was negotiated fairly and was bona fide. *Stevens Brothers and the Miller Hutchinson Co.*, 24 TC No. 106, *acq.* IRB 1955-10.

WHEN IS IT INCOME

Income accrued upon delivery of houses. [*Certiorari denied*] Taxpayer, on the accrual basis, contracted to manufacture and deliver 1,000 prefabricated housing units to the Federal Public Housing Authority, to be paid for as he submitted certified vouchers of delivery. On December 31, 1942, he delivered certain houses for which he submitted the required bill in January, 1943. Affirming the Tax Court, the Ninth Circuit found that the sale was made in 1942. The Authority's liability matured upon delivery of the houses and the mechanical act of filling out the necessary voucher could not postpone the accrual. *Dally, cert. den.* 4/23/56.

Transfer held mortgage, not sale; net rents for period are income when title litigation ended. Taxpayer in 1932 assigned a building subject to a mortgage to his attorneys. In 1938 he brought suit to establish that the 1932 assignment had been simply as security for bills for legal services. In 1947, it was finally established that taxpayer was correct and upon payment of about $10,000 (liens and interest less income) he could redeem. The Tax Court held that taxpayer had some $57,000 income in 1947, rents less operating expenses and depreciation for the period from 1932 on. This court agrees. The item was clearly income and, due to the litigation, it could not be income in any prior year. *Murray*, CA-9, 3/30/56.

Profit included in returnable-container account transferred to income. The Commissioner was held justified in transferring in 1942, 1943, and 1944 a portion of a brewer's "Reserve for Returnable Container Deposits" account to income. Taxpayer was a brewer on the accrual basis who had, between 1935 and 1944, built up a reserve of about $136,000. Experience showed it refunded about 95% of all deposits. The court held that the Commissioner's action was not unreasonable. *James Hanley Co.*, TCM 1956-99.

Estate settlement included income; heir taxable on it. Taxpayer renounced his rights under his wife's will and sought to force the executor to distribute to him his statutory one-half in actual assets of this estate, especially certain stock. In the interim the estate received income. A settlement was arrived at whereby, as a final and complete distribution, taxpayer received part stock and part cash. The cash was held to include his share of the income of the estate, on which he was liable for the income tax. *Delmar*, 25 TC No. 113.

Maryland ground rent not same as mortgage. Taxpayers built houses on land owned by them and then sold the houses and a leasehold for a term of 99 years, renewable forever. Pursuant to Maryland law, the builder retains legal title to the land and is the owner of the ground rent while the purchaser owns the house subject to payment of the ground rent and can purchase the land outright after 5 years. The Commissioner contended that the transaction amounted to a sale of the house and land with a mortgage retained and not a sale of the house alone. The court holds for the taxpayer, finding that the leases were bona fide, and gains with respect to the land arose only when the leases were sold to outsiders or the land was sold to the house owners. In a sale with a mortgage retained, the purchaser is obligated to make the payment. Under the Maryland law of ground rents, the purchaser of the house may buy the land but he is not obligated to do so. *Simmers*, CA-4, 3/21/56.

Business-interruption insurance taxable in year of interruption, not payment. Taxpayer, selling house furnishings, was on the accrual basis with a September 30th fiscal year, and reported its profits from sales on the installment method. On May 23, 1945, there was a fire in the taxpayer's store which resulted in the closing down of business operations until October 8, 1945. Subsequently, a settlement was received on a business-

interruption-insurance policy which the Commissioner contended should be split up between the taxable years in proportion to the number of days of shutdown in each year. The court agrees because the taxpayer was on the accrual basis. Although sales proceeds would have been reportable when received under the installment method, the recovery from the insurance company was in lieu of profits rather than sales, and therefore no consideration need be given to the installment method it used. *Cappel,* DC Ohio, 2/16/56.

OTHER ACCOUNTING CASES

Can't take worthlessness loss and charitable deduction for same stock. A bank examiner required that stock held by taxpayer-bank as an investment be charged off as worthless. When the Commissioner disallowed an addition to the bad-debt deserve for this charge-off, taxpayer claimed instead a capital loss for worthless securities. Subsequently taxpayer made charitable contributions of the stock, placing on it a substantial value for this purpose. The court holds that the bank examiner's action created only a rebuttable presumption of worthlessness and that the evidence, especially taxpayer's own actions, indicates that the stock had value. *Peoples National Bank,* DC Va. 3/27/56.

Net operating loss not affected by premium on wholly tax-exempt bonds. In determining a net operating loss, the amount of tax-exempt interest required to be added to statutory gross income (thus reducing the loss carryover) is the difference between the gross amount of interest received from wholly tax-exempt bonds and the amount of interest paid on indebtedness to carry the tax-exempt bonds, without any reduction on account of amortizable premium on such bonds. *Rev. Rul.* 56-161.

Loss on sale of property used in business is not "operating." Taxpayer was a partner in the operation of a veneer mill which became unprofitable in 1949. It was thereupon abandoned and written down to the salvage value for which it was sold in 1950. Taxpayer included this write-down in the 1949 net operating loss which he carried back to 1947. The District Court held that the loss was not sustained as an incident to the normal course of operations of a trade or business regularly carried on. [Under the 1954 Code such a loss is an operating loss. *Ed.*] This court affirms. ***Bratton,*** CA-6, 3/2/56.

Beneficiary not taxable on recovery of loss which didn't benefit estate. *[Nonacquiescence]* Taxpayer received a distribution on account of shares of bank stock inherited from her husband's estate. The estate had claimed deductions for an additional assessment on the stock and for worthlessness. The amount received by taxpayer as principal was less than the amount of the write-off, which produced no tax benefit to the estate. None of the recovery is taxable. *O'Brien,* 22 TC 661, *non-acq.* IRB 1956-5.

Collection from guaranty fund is bad-debt recovery. In 1932 taxpayer took over the liabilities of a failing bank together with its assets, its note for the difference, and a guarantee fund of $32,500 subscribed by townspeople anxious to prevent a bank failure. In 1942 taxpayer wrote off the balance due on the note of the other bank (and got full tax benefit) but left the guaranty fund untouched because of litigation over its disposition. In 1951 the litigation was settled and taxpayer took the fund into its unrestricted assets. The court holds that since the taxpayer got full tax benefit from the write-off of the loss, this recovery is taxable. It refused to accept testimony of two guarantors that they intended to make a contribution to capital. The agreement they signed was unambiguously a guarantee. *First Nat'l. Bank of Waco,* DC Tex., 3/30/56.

Criminal fraud in overstated deductions. *[Certiorari denied]* Taxpayer claimed various deductions, including contributions, casualty losses, and repairs to rental property. In one year, the contributions claimed were about $6,500. The government proved that these contributions were not made by check and the taxpayer did not have sufficient cash to cover them. On the basis of this and similar evidence, together with admissions by the taxpayer himself that he could not have made the claimed contributions, the court held that there was sufficient evidence for the jury to find a wilful evasion of income tax. *Zacher, cert. den.* 3/26/56.

Loans to mental patients worthless prior to taxable year; bad-debt deduction denied. Taxpayer, a machinist, had on numerous occasions advanced funds to mental patients to help them rehabilitate themselves. The Tax Court denied a 1952 bad-debt deduction for such loans. Assuming a debtor-creditor relationship existed, the debts were just as worthless before 1952 as they were in 1952. *Myrick,* TCM 1956-10.

Jury finds all condemnation proceeds invested forthwith. Taxpayer received some $27,000 in 1949 on condemnation of farm lands. In 1952 he bought farm land for about this sum. He paid tax on his gain and seeks refund on the ground that this was an involuntary conversion and the proceeds were reinvested forthwith. The jury finds for the taxpayer. *Fazio Estate,* DC Ore. 11/3/55.

THE ACCOUNTANT'S FUNCTION IN TAX MATTERS

I AM INCLINED to believe that the principal value of the knowledge we obtain is not that it will enable us to solve problems so much as that it will help us to detect the existence of problems.

This seeing in advance is perhaps the accountant's principal function in tax matters—whether it is the determination of the advantages and disadvantages of using some form of election, the detection that a company is evolving into a personal holding company or the observation of the fact that what a corporation proposes to do can be done, with better tax consequences, some other way. And the ability to see in advance must obviously be based on knowledge. Without it a troublesome situation can stare into the accountant's face without his knowing it is there. Once it is observed steps can be taken to arrive at the right answer but the accountant has fulfilled his most important function by spotting the problem. . . . *Wilfred Godfrey, vice president and treasurer, Keystone Custodian Funds, Inc., at the Second Annual Tax Forum, Northeastern University.*

TAX CONSEQUENCES OF

Corporate organization and distributions

EDITED BY JACKSON L. BOUGHNER, LL.B., CPA
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Stepped-up basis on assets transferred to newly-formed corporation?

by RICHARD R. TESCHNER & DALE L. SORDEN

How would you arrange matters so that your clients would, on incorporation of a partnership or proprietorship, achieve a gain recognized and taxed in order to achieve a new higher basis for this stock and for the assets transferred? In this situation, not uncommon in practice, we find many unanswered questions. The following discussion may give you some ideas.

A typical fact situation

The Reiter-Ronge partnership manufactures widgets. Its plant and specialized machinery are in good condition but old and almost completely depreciated. Because of general economic conditions and an upswing in the widget market, however, they have a rather high fair market value. The business needs money; because it is rather speculative and neither Reiter nor Ronge is too well off, borrowing possibilities are limited. Risk capital is needed.

A successful friend, Kash, is willing to supply it, but makes two conditions: (1) because of his own personal wealth and high tax brackets and the risky nature of the business, he wants to come in as a stockholder, not a partner; (2) the depreciable basis of the operating assets must be stepped up to reflect the value he is in effect "paying" for them. Although the assets to be contributed by Reiter and Ronge have an adjusted basis of only $10,000, their fair market value is $60,000; three-fifths of the stock is to be issued to Reiter and Ronge for the assets and two-fifths to Kash for $40,000 in money. Kash wants the company to be able to depreciate on $60,000, not on just $10,000. May this be done?

Section 351 of the 1954 Code says: "No gain or loss shall be recognized if property [including money[1]] is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such *** persons *** control *** [i.e., own stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation[2]] . . . the corporation. For purpose of this section, stock or securities issued for services shall not be considered as issued in return for property."

Under the former law, non-recognition of gain was lost unless each of the transferors received the stock and securities "substantially in proportion to his interest in the property prior to the exchange."[3] This "proportionate interest" requirement was deliberately eliminated in the new Code.[4] Under the old law it was relatively easy to make the transaction taxable by issuing the stock and securities disproportionate to the previous interests in the property transferred, balancing the accounts by also paying money out of the corporation,[5] or by some similar device. This avenue is now closed. What, if any, are open?[6]

There is no problem if an *existing* corporation is the transferee, provided more than 20% of at least one class of stock remains in the hands of "old" stockholders who are not in any sense a part of the "new" transferor "group". Such a transaction appears clearly to be taxable.[7] Query, however, if the corporation had been completely dormant since its inception, the cash originally paid in for its initial stock never having been put to any productive use?

On the other hand, so long as each of the persons who *together* receive 80% of each class of stock contributes some "property" no amount of disproportion and no amount of payment by the corporation in money or property other than stock or securities will assure the taxability of the exchange.[8]

Try as you may to achieve a different result by having the corporation issue preferred stocks, bonds, or even notes for some of the property and money it receives, in various proportions, or by selling common or preferred stock to "outsiders", there is no escape. So long as the corporation is newly formed and each of the persons who together receive 80% of each class of stock issued contribute or pay *something* in cash or other property, the statutory requirements are met. There may be gifts or compensation for services, but there will be no stepped-up basis.

Possibility of using boot provision

One proposal has been to use the boot provisions to get at least a partially stepped-up basis. In our example, let the corporation pay $25,000 in bonds and only $15,000 in stock to Kash and pay for $30,000 of the Reiter and Ronge assets in money or with short term notes. They will have $30,000 of recognized gain[9] and for this property the corporation will take their basis plus this $30,000 of recognized gain.[10] The diffi-

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[1] *Halliburton v. Com.*, 78 F (2d) 265; GCM 24415, 1944 C B 219.
[2] Sec. 368 (c).
[3] Sec. 112 (b) (5) IRC 1939.
[4] See both the House and Senate Committee Reports on HR 8300.
[5] e.g., see *Diescher v. Com.* 110 Fed (2d) 90, 40-1 USTC Par. 9233.
[6] Problems arising when incorporation is accompanied by sales of interests among the partners are not considered here. Sec. 55 J.T. 362.
[7] Regs. Sec. 1.351-1 (a) (2) *Example* (2).
[8] Regs. Sec. 1.351-1 (b) (2) *Example* (1).
[9] Sec. 351(b).
[10] Sec. 362 (a).
[11] See *Camp Wolters Enterprise, Inc.*, 22 TC 737.
[12] 293 U.S. 465.
[13] Compare Regs. Sec. 1.351-1 (b) (2) *Example* (2), where however, only 10% of the single class of stock was issued for services.

culty comes in establishing in the corporate case that the "notes" were not "securities"[11] and in allocating the increase in basis to depreciable assets.

Can any practitioner be sure in advance that the Commissioner won't succeed in allocating a substantial portion of the step-up to goodwill where it is a going partnership business which is incorporated? The device may nonetheless be very useful in particular situations. When the transferred assets have not previously been integrated into a single business, it may allow selectivity in having gain recognized on the assets transferred by one or some of the new shareholders and not on the rest.

For example, Roadmann, age 35, has a fleet of trucks which he has been passively renting, with an adjusted basis of $40,000, worth $65,000. Fieldfellow, age 55, unrelated, has land and a warehouse suitable for a truck terminal with an adjusted basis of $30,000 worth $70,000. They want to combine and engage actively in a truck-line business. Issue $40,000 of common stock to each, $30,000 of preferred stock or long term debentures to Fieldfellow, and $25,000 of cash (obtained by mortgaging the land to a bank) to Roadmann. The two have became equal shareholders in the future growth of the company; Fieldfellow has no gain or loss recognized; Roadmann has a $25,000 capital gain, the cash to pay the tax and an increased basis for his stock; the corporation has a stepped-up basis for the quickly depreciable trucks.

Temporary incorporation

Another suggestion has been to put the property on which an appreciated basis is desired into a corporation temporarily, then dissolve the corporation and take a single capital gain on complete liquidation under Section 331 with corresponding new basis under Section 334(a). Practitioners should certainly be alert to the possibilities of this situation if it occurs "naturally", but its utility as a deliberately planned device is to be doubted. First of all the special ordinary-gain provisions of Section 1239 will apply if this is essentially a one-man corporation. Second, the collapsible corporation rules may apply, again yielding ordinary income. Perhaps more fundamental, if the liquidation is planned at the time of the incorporation, what about *Gregory v. Helvering*?[12] It does not seem unreasonable to suspect that an incorporation followed closely by a pre-conceived liquidation might generate in the Commissioner and the courts a considerable resistance to granting stepped-up basis at capital gain rates.

A proposed way out

What then? Is there any *generally* applicable method by which an existing partnership business may be incorporated at a stepped-up basis? While there is not likely to be a definite answer to that for some time, practitioners are equally likely to keep trying. Consider the following.

Services are not property for purposes of Section 351. "Control" is not achieved by the transferors of the property unless they receive 80% not only of the voting stock but also of all other classes of stock. Why not create a preferred stock and issue it exclusively for services rendered by persons who do not contribute *any* property, for example, to the accountants, engineers and attorneys for their services in the creation of the new corporation, taking care that all their disbursements are paid by the corporation in cash so that they don't contribute any property?

If the professional firms won't or can't accept stock in payment for their services there may be a prospective officer or employee, not otherwise to be a shareholder, who will do so. If the stock is redeemable after a few years, sufficiently cushioned by common, and pays a reasonable dividend, the person rendering services may be quite willing to accept it. If enough is issued (and/or optioned?) so that the Commissioner can't claim *de minimus* and if the recipient is not so related to the transferors of property that it is arguable that in effect the stock was issued to them and then transferred by them as gift or compensation, what valid objection can the Commissioner make to allowing a stepped-up basis?[13]

Comment is invited. ☆

NAM proposes amendment of Code Sections 246, 248, 302

IMPORTANT AMONG the NAM's suggestions for amending the 1954 Code, recently submitted to the Joint Committee on Internal Revenue Taxation, is one to amend Section 246(b)(1), which limits the amount of the dividends-received deduction by providing that it may not exceed 85% of taxable income (computed without the dividends received deduction). However, Section 246(b)(2) states that the limitation prescribed by Section 246(b)(1) shall not be applicable to any taxable year in which the taxpayer has a net operating loss. Says the Association:

"The effect of Section 246(b) is illustrated in the accompanying example. In this example, Case #1 illustrates a situation where there is no limitation on the dividends-received deduction, Case #2 illustrates the effect of the limitation, and Case #3 illustrates the inapplicability of the limitation to a year in which the taxpayer has a net operating loss.

"A comparison of the three cases in this example illustrates that the taxpayer whose taxable income (computed without the dividends received deduction) equals or exceeds the amount of dividends received (Case #1) or which has a net operating loss (Case #3) obtains full benefit of the dividends received deduction. But the taxpayer which is in neither situation (Case #2) is penalized by the limitation of Section 246(b)(1). The severity of this penalty is highlighted in the above example, for if the Case #2 taxpayer had one additional dollar of operating losses its allowable dividends-received deduction would have been $850,000 rather than $722,500 and instead of having taxable income of

Example

	Case #1	*Case #2*	*Case #3*
Amount of dividends received	$1,000,000	$1,000,000	$1,000,000
Operating losses	— 0 —	150,000	150,001
Taxable income (computed without the dividends received deduction)	1,000,000	850,000	849,999
Dividends-received deduction	850,000	722,500	850,000
Taxable income	150,000	127,500	
Net operating loss			1

$127,500 it would have had a net operating loss of $1, the same as the taxpayer in Case #3.

Other NAM suggestions:

The NAM also suggests the following:

1. Amend Section 248(b), defining organizational expenditures, to include reorganization, registration, and stock listing costs.

2. Amend Section 302(a)(2)(A) so that "termination of interest treatment" to a taxpayer beneficiary of an estate or trust is not prevented by the "attribution of ownership rule" when the taxpayer has and has had no control over the property held by such estate or trust. This amendment is entirely consistent with the parenthetical phrase ("other than stock acquired by bequest or inheritance") in Section 302 (a)(2)(A)(i)(ii).

"Section 302(b)(3) of the Internal Revenue Code of 1954 in effect provides for capital gains treatment with respect to a redemption of stock which completely terminates a shareholder's interest in a corporation. Section 302 (c)(2) provides certain safeguards and specific tests that must be met in order to qualify for this treatment. This section further provides that the rules of constructive family ownership shall not apply in the case of complete termination of a shareholder's interest, but it does provide for the application of the constructive ownership rules with respect to partnerships, estates, trusts and corporations. Since these rules provide that stock owned by any beneficiary of a trust is attributed to the trust and stock owned by a trust is attributed to its beneficiaries, it is not possible for an individual shareholder to completely terminate his interest in a corporation under the provisions of this section as long as any other beneficiary of a common trust owns a single share of stock in the same corporation. There appears to be no logical reason for eliminating attribution with respect to direct family holdings while requiring the application of the attribution rules with respect to interests in estates or trusts in the situation where a shareholder wishes to completely terminate his interest in a corporation." ☆

Tax hurdles the real estate investor faces in using corporate form under 1954 Code

EVERYONE WHO LIVES west of the Hudson River says New York is "a fine place to visit, but I wouldn't want to live there." Well, let us tell you that one advantage of "living there" is that you get to hear some very high class tax talk without much effort. We went around to the luncheon meeting of the Federal Bar Association (Arnold Hoffman, chairman) last month at the Shelton Hotel to listen to Milton Young on the subject of the tax trials of the real-estate investor under the new Code. While the Code provisions involved are getting pretty well known, the curious way they operate with respect to the real estate corporation are not. Mr. Young, who is with the New York law firm of Young, Kaplan & Edelstein, did us the great service of pulling together all this stuff and showing us how it affected the real estate investor. Here is the essence of what he said:

It is curious that our federal tax laws should contain so many difficulties for the real estate investor. The taxpayer who purchases a publicly traded security need look only to his holding period for an assured capital gain, if he sells at a profit. This is so despite the frequency of his transactions or the amount of money he may make, so long as he is not a dealer.

The real estate principal must be on guard from construction to destruction; from acquisition to disposition; from corporate formation to corporate liquidation. If through a corporation he builds and sells or buys and sells, or receives money or property from his corporation prematurely, he may find himself the unwilling recipient of substantial ordinary income.

His main causes of trouble are the collapsible corporation provisions of the Internal Revenue Code of 1954. Other provisions of the new Code are helpful to real estate operations, particularly the new depreciation rates; the elimination of the former double tax danger when property is sold by shareholders after a corporate liquidation; the change in the definition of personal holding company income; and the new accumulated earnings credit of $60,000.

In response to some of these changes, new techniques in planning real estate operations are being evolved to meet these new conditions.

In the Second Circuit Court of Appeals, the propriety of these shifts in business forms was recently acknowledged, when the court said (*Kraft Foods Co. v. Commissioner*) on April 2nd:

"There is no doctrine that taxpayers cannot adjust their affairs in response to a change in the tax law so as to reduce taxes. Indeed, the structure of the tax law deliberately recognizes tax-conscious motivations and seeks both to encourage them (e.g., rapid amortization of defense facilities, Sections 124, 124A, and charitable deduction for gifts of appreciated property) and to discourage them (e.g., surtax on unreasonable accumulation of surpluses, Section 102, and provisions in Sections 24 and 45 relating to transactions between related taxpayers)."

Look at some of the changes and responses in the field of real estate transactions.

The principal change in this area is the liberalization of the rules for a tax-free exchange of property for stock in a newly formed corporation. Formerly, if A owned a building worth $100,000 and B owned a building worth $30,000, and if A and B transferred their respective properties to a new corporation, each receiving one-half of the stock, the exchange would be taxable because of the disproportion between the value of the respective properties transferred and the stock received. Under the new law such a transfer could be made, and despite any disproportion, the exchange, if it otherwise meets the statutory requirements, will be tax free. This change may be of particular interest in situations where the transferor of lesser property, receiving equal shares, may be a professional operator or promoter. To the extent of course that the disproportion in stock results in gift or compensation, tax consequences result which are not presently pertinent.

Penalty taxes

Real estate corporations under the 1939 Code were classified as personal holding companies when the principal source of income was rent received from stockholders. The identification of a corporation as a personal holding company required it to distribute all of its net income, after taxes, in order to avoid the imposition of a severe surtax. The Internal Revenue Code of 1954 has

changed the definition of personal holding company income by virtually eliminating compensation for the use of corporate property by a shareholder as one form of such income. The practical effect of this change is to permit a corporation to lease property to a shareholder (at a fair rental, of course), with tax benefits to the corporate landlord and the shareholder tenant. Hence one probable response to the change would be the increased use of corporations for the ownership of property housing a family business.

Under the 1939 Code, even real estate corporations were subject to the penalty surtax for improperly accumulating surplus. The Internal Revenue Code of 1954 contains some liberal provisions for the benefit of corporations which may have attracted some vulnerability to the surtax. One of the changes is the availability to every corporation of an accumulated earnings credit of $60,000.

The response to this change is to further encourage the use of corporations for certain modest real estate operations.

Corporate liquidation

The most important changes affecting real estate transactions are the new collapsible corporation provisions. Under the 1939 Code, the definition of a collapsible corporation was more or less limited to corporations engaged in the manufacture, construction or production of property. Where a premature sale of stock or distribution of property took place, the resultant gain was treated as ordinary income. The 1954 Code expanded the definition of a collapsible corporation so as to include corporations which purchased certain property. Among the assets meeting the new statutory definition is real property used in the trade or business. Thus, a corporation formed to purchase an apartment house may be deemed collapsible if within three year after the purchase it is liquidated or its stock sold.

Of course, the rules governing collapsible corporations are not as simple as this brief summary would indicate. For example, a taxpayer may establish an intent not to prematurely sell stock or liquidate before the realization by the corporation of a substantial part of the taxable income to be derived from the property; or he may be able to establish that less than 70% of the gain realized is attributable to the tainted property.

The responses to this change are many. When a sale is anticipated within three years after the completion of construction or the date of purchase, to the extent practicable the corporate form is not used. This avoidance in turn may require the use of individual nominees or temporary corporations to avoid personal liability on contract or on a purchase money bond and mortgage. These uses in turn, if not carefully planned, may produce tax problems of their own.

Another response is to seek the elimination of the realized gain which attracts the collapsible corporation attack. Tax-free reorganizations involving real estate corporations may be one answer — but many principals have found this device, while theoretically appealing, of dubious practicality.

Finally, the use of deferred payment sales has been increased in order to bring the realization of income beyond the three-year period.

The collapsible corporation problem

Unfortunately, the preposterous extension of the collapsible corporation rules to conventional purchases of real estate has acted as a deterrent to what otherwise would be the free purchase and resale of real estate parcels in an active market. The use of the corporate form is essential in many cases and unless one is quickly extricated from the corporate trap, property may be locked in for more than three years.

Under the 1939 Code, one method of preventing the collapsible corporation result was to postpone the realization of gain by a tax-free liquidation within one calendar month. Under this rule a corporation would be liquidated without the recognition of gain or loss to shareholders except to the extent of treating earned surplus as ordinary income and certain excess cash and securities as capital gain. In many real estate corporations, property had appreciated in value with no concurrent substantial accumulation of earnings. This section permitted the transfer of constructed property within the three-year period without the danger of treating the gain on liquidation as ordinary income. Unfortunately, the Internal Revenue Code of 1954, which contains a similar one-month liquidation provision, excludes collapsible corporations from the benefits of the section.

One of the most serious problems which real estate investors faced under the 1939 Code was the double tax resulting from the disposition of property which had been held in corporate form immediately before the sale. The Internal Revenue Code of 1954 attempted to ameliorate the situation by providing that no gain would be recognized by a corporation which sells property within a year after the adoption of a plan calling for its liquidation within the year. Again, the benefits of this section are denied the collapsible corporation.

One response to the change is to use this section even in cases of apparent vulnerability under the collapsible corporation provisions. In other words, the new law permits corporations to pay no tax on gain from the disposition of assets, assuming of course the other provisions of the section are met. If a corporation were to sell property and subsequently the Commissioner were to deny to that corporation the benefits of the section, the result would simply mean a payment of tax on the corporate level and a decreased capital gain by the shareholders. If the property to be sold is real property which qualifies for capital gain treatment upon a corporate disposition, then in effect the maximum tax to be paid by both the corporation and the shareholders, assuming the collapsible nature of the corporation is successfully established, is 43%.

One complication which the use of the section presents is the treatment of installment obligations received by the corporation on the disposition of its property. For example, if a corporation owning real property were to sell it and receive less than 30% in cash and a purchase money mortgage for the balance, the benefits of an installment sale will be denied the shareholders when upon liquidation of the corporation they receive all of its assets, including the cash and the purchase money mortgage. If the mortgage is valued at less than face, and if the face amount is ultimately collected by the shareholders, the difference will be ordinary income. One response to this problem is to dispose of the mortgage prior to maturity in order that the difference between the amount at which it was valued and its ultimate fair market value might be treated as capital gain. ☆

New decisions

Accrued interest a "security" in a nontaxable exchange. [*Acquiescence*] Taxpayer exchanged debentures on which

considerable unpaid interest had accrued for cash and new securities. It claimed this was a nontaxable exchange in reorganization. The Tax Court agrees; the accrued interest is an integral part of the debenture, and the principal debt plus the interest is a "security." No gain was recognized on the exchange. *United Gas Improvement Co.,* 25 TC No. 32, *acq.* IRB 1956-18.

Ratio of debt to capital of 180 to 1 too thin. Upon formation of a corporation, the incorporators invested $500 in stock and advanced $90,000 on promissory notes secured by a chattel mortgage. Even though the facts indicated a formal debtor-creditor relationship, the court held there was no substance to the "loans"; the $90,000 was immediately placed at the risk of the business in the same manner as the capital of a normal corporation. The fact that there was a disproportion in each stockholder's interest in the advances and stock was not considered incompatible with a finding that the debt was really capital. It was in the nature of a preferred stock interest. Accordingly, a loss resulting from the subsequent sale of the "notes" was considered a capital loss. *Gale,* TCM 1956-103.

DIVIDEND QUESTIONS

Parent's basis for property unchanged through sale to subsidiary and recovery as property dividend. Taxpayer, in June 1946, sold land to its subsidiary at its cost. The parent had no cost for the gas rights. At the time, negotiations for sale of gas rights under this land were alive but not active. In December a price was settled. Five days later the subsidiary declared a dividend in kind of the gas rights (ordinary income to parent of 15% of value of $230,000). The parent then sold the rights for $230,000. The Tax Court found no business purpose; taxpayer did not meet the burden of showing error in Commissioner's position that capital gain of $230,000 was realized. This court affirms. The Tax Court's inference from uncontested facts is itself a finding of fact. The Tax Court not only gave consideration to all the circumstances, it also arrived at the proper conclusion. *Weyl-Zuckerman,* CA-9, 3/27/56.

Crediting surplus to stockholders does not create a liability; payment is dividend. A corporation reduced its no-par common stock from $50,000 to $2,500 in 1936 by crediting its capital surplus for $47,500. In the following year the capital surplus was transferred on the corporate books to the separate accounts of the stockholders. The court held the transfer did not create a debt; a payment in 1948 to a stockholder of the amount set up in his account constituted a dividend distribution in that year. *Miller,* 26 TC No. 11.

Subsidiary's redemption of preferred stock held dividend. Subsidiary redeemed its preferred stock (originally issued in exchange for bonds, notes, cash, and salaries payable, and later purchased by parent) from parent at latter's cost. Despite its finding that this redemption was but one step in a total liquidation of the subsidiary which had been contemplated for six years prior thereto and which was completed three years later, the court held the net effect of the distribution to be essentially equivalent to a dividend under 1939 Code Section 115(g). [The company argued that the redemption was a partial liquidation (presumably untaxed as recovery of cost) not a dividend against which presumably an 85% credit would be allowed. *Ed.*] *Rockwell Spring & Axle Co.,* DC Pa., 3/29/56.

One redemption equivalent to a dividend; another not. In order to permit a key employee to acquire a one-third interest in a corporation, the corporation retired a portion of the shares of a corporation whose majority stockholder continued to be a majority stockholder after the transaction. The IRS holds the redemption essentially equivalent to a dividend. The net effect was to distribute earnings without appreciable change in the position of the parties. *Rev. Rul.* 56-182. Family trusts which held about 11% of the stock of a corporation sold to the corporation 2% of the outstanding stock in order to be able to diversify their investments. More than 89% of the stock was at all times held by unrelated stockholders. The Service says that on the basis of these facts, this redemption is not essentially equivalent to a dividend; it is a distribution in full payment for the stock to the extent that the redemption price did not exceed fair market value. *Rev. Rul.* 56-183.

Sole shareholder gives shares to settle debt; redemption a dividend to him. Taxpayer, the sole stockholder of a corporation, transferred a portion of his stock to a third party in settlement of a personal agreement. The latter immediately sold the stock to the corporation for $20,000. The court held that the corporate payment of $20,000 was in discharge of taxpayer's obligation in like amount and accordingly taxpayer received a dividend of $20,000. *Ferro,* TCM 1956-94.

Cash paid to stockholders prior to merger a dividend. In connection with a tax-free merger, the corporation made a cash distribution of its earnings to its shareholders prior to the exchange. The entire amount of the distribution is treated as a taxable dividend. *Rev. Rul.* 56-184.

TAX FREE EXCHANGES

Corporations having no business functions ignored in attempted tax-free reorganization. Taxpayers, husband and wife, and two other equal stockholders in E Corporation had a falling-out. It was agreed that taxpayers would receive one-third of the corporate assets in exchange for their stock, these assets to be transferred to a new corporation. This was done. But taxpayers did not turn in their stock for this new subsidiary. Instead they created D Corporation and transferred their E stock to it. B Corporation, owned by taxpayer-wife, purchased the E stock from D Corporation for cash and notes, and exchanged E stock for subsidiary stock. Neither B Corporation nor D Corporation ever engaged in any business activity. The court accepts the allegation of taxpayers that their purpose was to insulate the subsidiary stock from the claims of taxpayer-husband's creditors. The court finds, nevertheless, that B Corporation and D Corporation must be disregarded, since they engaged in no business activity and since there was no bona fide intention that they should have any real substantial business function. Accordingly, the transaction is treated as though the taxpayers had directly exchanged with E Corporation their stock in E Corporation for the stock of L Corporation, a taxable transaction. The Tax Court is affirmed. *Jackson,* CA-2, 5/3/56.

Mere conduit in merger is not a party to the reorganization (old law). Taxpayer was one of the stockholders in an operating company the majority stock-

holder of which wanted to merge this subsidiary with another. Fearing it would not be able to persuade enough of the minority to vote for a merger of the two subsidiaries, it merged this subsidiary with itself. Taxpayer received stock of the parent and claimed it to be a nontaxable exchange. The court pointed out that as planned, the parent immediately transferred the assets it received in merger to a newly-created subsidiary and caused that new subsidiary to merge with the other, thus achieving its goal. In this whole transaction the parent acted merely as a conduit; therefore, under the *Groman-Bashford* rule, it was not a "party to the reorganization" and taxpayer's receipt of its stock is taxable. [The 1954 Code contains a new definition of "party to a reorganization" intended to remove the restrictions of the *Groman-Bashford* rule. *Ed.*] *Cooke,* TCM 1956-102.

No carryover of basis; stockholders bought assets for cash from trustee. Taxpayer claimed that in computing its EPT credit it could include as the basis of its assets their basis in the hands of a predecessor corporation. The predecessor was in bankruptcy in 1934 and taxpayer was organized by stockholders of the old corporation and its stock issued to them for "goodwill." It purchased the assets of the old corporation at public auction for some $48,000. This, the Tax Court held, was not a tax-free exchange; the property was acquired for cash, not for stock or securities. Moreover, there was merely an auction sale, not a plan of reorganization. This court affirms. *Goldstein,* CA-7, 4/11/56.

Gain to extent of accrued dividends is taxable on exchange. First-preference stockholders, pursuant to a recapitalization, exercised their option to exchange their shares for common stock, debenture bonds, plus accrued cash dividends. Gain is recognized but is limited to the amount of cash and the fair market value of the bonds received. Such gain, to the extent of the accrual dividends, is taxable as a dividend. *Rev. Rul.* 56-179.

OTHER CORPORATE CASES

Stockholders have capital gain on sale of subsidiary stock to their corporation despite subsequent subsidiary dividend. Taxpayer was owned by members of two families. Taxpayer owned 50% of a subsidiary, its stockholders 15%, and a supplier, 35%. The supplier wished to sell its interest and taxpayer decided to acquire all the subsidiary shares. It agreed to pay its stockholders $127.50 a share (conceded to be a fair price) and bought them on October 31st. The same day the subsidiary declared a dividend of $77.50 a share, payable November 7th. On November 8th, taxpayer bought the shares owned by the supplier for $50. The Commissioner treated $77.50 of the price received by the individuals as a dividend. This, the court holds, was completely unjustified. The dividend and the lower price were, it said, "obvious steps of tax avoidance" for the supplier (a corporation seeking a dividend with 85% credit) but did not color the individuals' sales. However, the corporation is not allowed a loss claimed on its subsequent sale of these shares to stockholders for $50. The only motive of the sale was to establish a loss. *Charles Dreifus Co.,* DC Pa., 3/16/56.

Subsidiary may deduct interest on dividend debentures, though tax-saving was sole motive. Taxpayer, a profitable cheese manufacturer, filed consolidated returns with its parent prior to 1934. Due to heavy interest obligations of the parent, largely on bonds issued to acquire operating subsidiaries, the parent had losses. In 1934 Congress revoked the right to file consolidated returns. Taxpayer thereupon declared a dividend of thirty million dollars in debentures. The Tax Court denied a deduction of interest on these bonds in later years on the ground there was no intent to create a genuine debtor-creditor relationship. This court reverses; this conclusion of ultimate fact from stipulated facts is erroneous. The debentures were a valid indebtedness, the parties intended to create a legal, binding debt. Nor is it required that for tax purposes the payments be treated as dividends because of (1) the parent-subsidiary relationship (Congress was at that time requiring that these corporations be considered as entirely distinct); (2) initial equity was transformed to debt (this factor is important in considering hybrid securities; these are legitimate debts); (3) thin capitalization (again important in determining other credit rights as against hybrid securities; but here real values, not on books, were so great that the debt did not make the corporation thin), (4) lack of business purpose (these transactions did not create sham corporations or sham documents, they had real effect). *Kraft Foods Co.,* CA-2, 4/2/56.

No Section 102 surtax on service organization; it needed cash to expand. Welcome Wagon, Inc., operates as a service organization selling no products and having no inventory. It has women employees called "hostesses" in various cities throughout the U. S. who make personal calls upon persons expected to be heavy purchasers (new mothers, new homeowners, brides-to-be, etc.) to present samples and gifts from commercial sponsors who pay a fee for each call. As a service organization, it was unable to secure an open line of bank credit; it also was planning to expand its operations in Europe. On these facts the court finds the large cash reserves were not unreasonable and refuses to sustain the Section 102 penalty surtax. *Briggs,* TCM 1956-86.

Collapsible doctrine not applicable to sale by stockholders. Section 117(m) of the 1939 Code relating to collapsible corporations has no application to a gain realized in 1953 by the corporation's former stockholders from the ultimate sale of real estate received in a liquidation within one month under Section 112 (b)(7). *Rev. Rul.* 56-160.

Must tack on holding period of old to new stock in tax-free exchange. For purposes of corporate distribution under the one-month liquidation provisions of Section 333, the acquisition date of stock acquired in connection with a tax-free exchange is the date the surrendered stock was acquired. *Rev. Rul.* 56-171.

District court reversed on allowing only $7,600 of $16,600 salary claimed. Taxpayer's salary as manager of several cafeterias had been set in 1935 at $7,600, and he had received about that amount each year until 1943, when he acquired full ownership of the corporation and increased his salary to $16,600. This he justified by his extremely long hours during war years, the loss of managerial help, and the unreliability of other help. This court finds the district court was clearly in error in putting the reasonable value of his services at only $7,600. Taxpayer met the burden of proof on that point; as to the excess, the government didn't show $16,600 unreasonable. *Baltimore Dairy Lunch,* CA-8, 4/12/56.

TAX STRATEGY NEWS OF THE REVENUE SERVICE

Effective tax procedures

EDITED BY MARTIN M. LORE, LL.B. CPA

CPAs' survey reveals flaws in handling of cases by Revenue Service personnel

Reports of threats and pressure in connection with requests for waivers and to force agreement with agents' findings are among the current practices being encountered by CPAs in their dealing with IRS personnel. These views, together with many others less critical of IRS, are reported by the American Institute of Accountants in a memorandum recently sent to the Commissioner.

The survey, conducted under the sponsorship of AIA's federal tax committee, J. S. Seidman of New York, chairman, produced comprehensive reactions from CPAs with respect to their day-to-day work with the IRS. Altogether 1,523 questionnaires were furnished by AIA members, from all IRS Regions. While the general tone of the mass of data obtained is by no means unfavorable, there are certain facts reported which are considered by many experienced tax men to be shocking.

Significant minority revealed

In writing to the Commissioner Mr. Seidman pointed out that while on almost every question more CPAs reported favorably than unfavorably, the dissents were significant. "For example," he said, "on Item 10, the box score showed 977 reporting that they do not experience pressure or threats by agents in connection with requests for waivers. However, 411 reported the opposite. The fact that there should be any opposite experience will undoubtedly enlist your attention.

"In Item 13, for example, 563 reported that they *do* experience pressure by agents to agree with their findings, through threats of penalties, disallowance of deductions, etc. (855 said the opposite.)

"In Item 16, 409 reported that the Service does *not* endeavor to settle individual tax issues at the lowest possible level but insists on an all-or-nothing affair for all issues. (776 said the opposite.)

"In Item 21, 214 declared that the Appellate Division *does* raise new issues instead of confining conferences to the issues presented to it. (505 said the opposite.)

"In Item 23, 412 reported that the sending of bills to taxpayers for installments on estimated returns *is* unduly delayed. (945 said the opposite.)

"In Item 25, 574 reported that many errors in the District Director's records *are* found regarding taxpayers' accounts. (845 said the opposite.)

"In Item 27, 260 reported that morale of Service personnel *is* adversely affected because of lack of respect for the quality of supervisors. (431 said the opposite.)

"In Item 28, though the total vote was the other way, 110 reported that they *do* experience inordinate delays in receiving rulings from Washington on partnership fiscal years; 146 reported similarly in respect to ruling requests on change of accounting method; 174 in respect to exempt organizations; and 236 in respect to technical rulings.

"Conversely, though 686 reported no improvement in effectiveness of agents' examinations compared with a year ago (Item 11), as many as 450 felt that there *was* such improvement.

"Likewise, though 709 felt that revenue agents have been deprived of the discretion that they used to have to settle cases because of group supervisor procedures (Item 12), 553 reported the opposite to be true.

"Another close vote was Item 22 where 321 reported that compared with a year ago the Appellate Division is not more effective in settling disputed items; but 196 answered the other way.

"Items 27 and 28, dealing with morale factors in the Service and delays in Washington rulings, likewise showed narrow margins in the votes.

"On many items there was a high degree of 'no opinion.' This was particularly true on Items 18 to 22, 27 and 28.

"Some of the comments that came with the returned questionnaires should be mentioned. Most of them amplify the responders' views on the items covered in the questionnaire. However, there is also considerable additional territory covered by the comments. There are repeated references to delay or failure on the part of the district offices to answer correspondence. Many comments have to do with difficulties in getting tax forms. Some report that agents are apprehensive of petty adjustments and a narrow attitude by the review section.

"There are also comments to the effect that new agents need better indoctrination in that, at present, some approach their work with a 'gestapo' attitude as if each case were a fraud case. Some responders make similar comments about attitudes on office audits and the impaired public relations that result."

Over-all results of study

Mr. Seidman wrote further as follows:

"On the basis of the prevailing overall vote, these conclusions are indicated for the 29 items covered in the questionnaire:

1. Not many cases are assigned for office audit that should be audited in the field (except in Atlanta).

2. Not many cases are assigned for field audit that should be audited in the office.

3. Agents do not generally make less careful examinations where the taxpayer has incomplete records than when the records are complete.

4. Examinations by agents of inventories are generally inadequate.

5. Surprise visits by group supervisors to agents working in the field are not generally a desirable procedure.

6. Agents are generally more intent on a "change" case than a complete examination.

7. New revenue agents generally require greater substantiating evidence than necessary, but not so with experienced agents.

8. New revenue agents generally have a tendency to "split hairs," but not so with experienced agents.

9. Agents generally view the particular period under examination without

regard to the offsetting effects in the surrounding years.

10. Pressure or threats by agents are not generally experienced in connection with requests for waivers.

11. Compared with a year ago, agents' examinations are generally not more effective.

12. Because of group supervisors' procedures, agents generally have been deprived of the discretion they used to have to settle cases (except in New York and Philadelphia).

13. Pressure by agents to agree with their findings, through threats of penalties, disallowance of deductions, etc. is generally not experienced.

14. Agents are generally inclined not to make decisions for themselves but rather to leave the decision to a higher authority.

15. Compared with a year ago, it is generally not easier to settle issues with agents.

16. The Service generally endeavors to settle individual tax issues at the lowest possible level, rather than an "all or nothing" affair for all issues.

17. The group supervisor conference is generally not in reality an independent review, because the group supervisor has prejudged the issues.

18. Group supervisors are generally not inclined to send cases to the Appellate Division merely because the Appellate Division has an insufficient volume of cases.

19. Compared with a year ago, the group supervisor conference is generally not more effective in disposing of disputed items.

20. Unreasonable delay is generally not experienced in obtaining a conference with the Appellate Division.

21. The Appellate Division generally does not raise new issues instead of confining conferences to those presented to it.

22. Compared with a year ago, the Appellate Division generally is not more effective in settling disputed items.

23. The sending of bills to taxpayers for installments on estimated returns is generally not unduly delayed.

24. Taxpayers generally have difficulty in understanding the bills they get from the Service for amounts due on quarterly installments.

25. Generally, not many errors in the District Director's records are experienced regarding taxpayers' accounts (except in Chicago).

26. Generally, there is no abuse in the use of jeopardy assessments for ordinary cases.

27. These factors are generally at work in adversely affecting morale of Service personnel: slowness of promotions (except in Omaha), promotions without regard to merit (except in Omaha), use of examiners for clerical work, continued reorganization of various departments, and insufficient or inadequate mechanical equipment. These factors are generally not at work in affecting morale of Service personnel: delay in getting credit for production because of the time cases are held for review (except in Boston and Philadelphia), and lack of respect for the quality of supervisors under whom staff members work.

28. Inordinate delays are generally not experienced in receiving rulings from Washington in respect to partnership fiscal years, changes of accounting method, exempt organizations (except in Boston), and technical rulings (except in Boston, Chicago and New York).

29. If revenue agents were freed from helping taxpayers prepare returns during the rush period, the accountants in turn would not generally be free to work with the revenue agents on their audits in the regular way.

30. The accountants are generally not in favor of restoring March 15 as the due date for returns of individuals. ☆

Procedures outlined for ministers, other religious professionals, to obtain OASI

STEPS TO BE TAKEN by ministers, certain members of religious orders, and Christian Science practitioners who elect social security coverage were recently outlined by officials of the Internal Revenue Service. Those who are qualified to be covered by the social security system may elect coverage by filing Form 2031 with their District Directors of Internal Revenue.

An election to be covered for 1955 and subsequent years must be filed on or before the due date of the income tax return for 1955. Copies of Form 2031 may be obtained from any District Director or from any office of the Social Security Administration.

When an individual has filed Form 2031, his earnings as a minister, member of a religious order, or Christian Science practitioner are treated as self-employment income, even though such income may in fact be earned by him as an employee.

In addition to filing a "U. S. Individual Income Tax Return," Form 1040, he must also obtain, and file with the Form 1040, a Schedule C (Form 1040), "Profit (or Loss) from Business or Profession." Page 3 of Schedule C (Form 1040) is used for the reporting of self-employment income and the computation of self-employment tax.

If a minister, member of a religious order, or Christian Science practitioner has business or professional income and expenses which involve the preparation of a profit and loss statement, he will also use page 1 of Schedule C.

However, if the individual is an employee, he ordinarily shows the amount of his salary and honoraria on line 5, page 1, of Form 1040. If the gross amount is properly reducible by traveling, transportation, or reimbursed expenses, he shows only the net amount on line 5 of Form 1040, and attaches to Form 1040 an explanatory statement showing the gross amount, the expenses, and the remaining net amount. If no other expenses are incurred in earning the income, the same net amount will also be entered on line 28 (c), page 3, of Schedule C and no amounts will be shown on page 1 of Schedule C.

On the other hand, if other expenses are incurred in earning the income, *and deductions for such expenses would be allowable if itemized on page 2 of Form 1040,* the net amount to be entered on line 28 (c) of Schedule C will be computed by subtracting the amount of such other expenses from the amount entered on line 5 of Form 1040. This computation also should be shown in a statement, to be attached to the return, explaining the amount on line 28 (c). The amount of self-employment tax will be shown both on line 34 of Schedule C and on line 15 of Form 1040. ☆

New decisions

Release of lien following tentative carryback claim does not extinguish tax. The government filed liens on taxpayer's property upon his and his wife's failure to pay their 1946 tax. Upon their filing a claim for a tentative loss carryback from

1947, the liens were released. The Tax Court held that the mere release of the liens did not extinguish the tax liability for 1946. This court affirms. Taxpayers showed no basis for estoppel. *Miller,* CA-5, 3/27/56.

Divorce court charged husband with community-property tax; he can't get refund. Taxpayer and her former husband filed separate returns. The Commissioner asserted additional tax against her on the ground that some income reported by the husband was community income, taxable to her. The Tax Court approved but this court reverses. The Commissioner's only basis for assessing taxpayer-wife was that the former husband had sued for refund of the tax incurred because he included the entire community income on his return. This court says that if that refund claim is invalid the case against the wife falls. And that claim is invalid because the husband did not in reality pay the tax—the divorce court awarded the wife one-half the community income less tax. She really paid the tax. *Harrold,* CA-9, 4/2/56.

Plaintiff in antitrust suit must produce income- and admissions-tax returns. Plaintiff, suing a motion-picture distributor for damages suffered as a result of distributor's alleged conspiracy in restraint of trade, made his own loss of profit an issue. His books and records being incomplete, he must produce his federal income-and admissions-tax returns and state income-tax returns. *Greene v. Lam Amusement Co.,* DC Ga., 3/9/56.

U. S. citizen can't be forced to produce books of his corporation, nonresident and not doing business here. The IRS directed a summons to taxpayer to appear to testify and to bring the books of his wholly-owned Panamanian corporation, which had never done business here. The corporation previously moved to vacate the summons because it was issued to taxpayer in his capacity as president, and the government had no authority over this nonresident corporation. It was decided that the summons was to taxpayer in his personal capacity. Now he moves to vacate the summons. This the court does to the extent it seeks production of the corporate books. The government has no jurisdiction over taxpayer in his corporate capacity and in his personal capacity he can assert the Fifth Amendment. The court takes no position, because the question was not raised, on whether he must appear to testify, though he can refuse on grounds of incrimination to answer improper questions. *Daniels,* DC NY, 4/10/56.

Interest on deficiency held to run from date of judgment. During receivership of taxpayer-bank, its funds were on deposit with the Comptroller of the Currency. Upon settlement of the long litigation over tax deficiencies, the court holds that the general rule that interest runs from the due date of the return is applicable. The U. S. Treasury has had the use of funds in dispute, therefore interest on the deficiency finally determined should run from the date of judgment. *Commercial National Bank of Shreveport,* DC La., April 1956.

Refund accrues when Commissioner signs list, not when Joint Committee fails to act. [*Certiorari denied*] Taxpayer brought suit for interest on a tax refund. Since the Code provides no special limit on time for filing, the general six-year rule applies. The period runs from the time the claim accrued, i.e., the time the refund was allowed. The Code provides that the date of allowance of a refund is the date of the Commissioner's signing the assessment list. The Court of Claims held that this rule is not affected by the fact that a refund of the size made to taxpayer could not be paid until thirty days after disclosure to the Joint Committee. *Engineers Public Service, cert. den.* 5/14/56.

Refund claim did question figuring as well as principle; suit based on improper allocation allowable (old law). Taxpayers sold their citrus grove in 1945 when green fruit remained on the trees. They reported the entire proceeds of sale as capital gain. The Commissioner allocated part of the purchase price to the green fruit which he taxed as ordinary income. The district court held that neither the pleadings nor claims for refund raised the issue of the accuracy of the allocation. This court holds that taxpayers could not claim that the Commissioner "erroneously determined that $94,000 represented profit . . . from the sale of fruit on the trees" raised the issue of the correctness of the allocation. Summary judgment for the government below was error. [Under the 1954 Code a crop sold with the land is a capital asset. *Ed.*] *Burrell,* CA-5, 4/12/56.

Assessment is prima facie correct in civil suit by government. In a civil suit to collect income taxes assessed, taxpayer failed to overcome the prima facie correctness of the assessment. The court rendered judgment for the government. *Whetstone,* DC Ill., 12/7/55.

Defense of statute of limitations is fact question for Tax Court. The Tax Court dismissed an amendment to the Commissioner's pleadings. On appeal by the Commissioner, taxpayer contended that it was apparent on the fact of the pleadings that the applicable statute of limitations had expired. The court holds that the defense of the statute of limitations is a question of fact to be passed on by the Tax Court, and remands the case for such consideration. *Seminole,* CA-5, 5/8/56.

Fraud not proved; failure to sign return keeps statute open. The Commissioner failed to prove fraud, and thus the statute of limitations barred an assessment. However, for years in which taxpayer failed to sign returns, the statute did not start to run. The Tax Court is affirmed. *Hamilton, Jr.,* CA-6, 4/9/56.

Barred refund allowed as equitable recoupment. Deficiencies in income tax for years prior to decedent's death were paid after the period of limitations had expired for claiming refund of estate tax arising from reducing the estate by these liabilities. Accordingly, the claim for refund of estate tax was disallowed by the Commissioner. The executrix then filed timely claim for refund of income tax in the amount of the estate-tax refund originally claimed. The court allows the claim under the doctrine of equitable recoupment, finding that the barred claim and the deficiencies were the result of a single transaction, and that to do otherwise would subject a single fund to double taxation. *Herring Estate,* DC N.C., 4/24/56.

Gross community income reported on partnership form is not omitted. [*Acquiescence*] Taxpayers reported the income from the husband's business (which was community property) on a partnership form and included only one-half the net on their separate returns. The Commissioner argued that by this procedure taxpayers omitted 25% of the gross income, so that the 5-year statute of limitations applied. If the business had been a valid partnership the Com-

missioner conceded that the procedure would have been proper. The Tax Court holds that the returns must be read together and that there was no omission. *Rose,* 24 TC 755, *acq.* IRB 1956-18.

Section 3801 won't open closed years for retroactive election of inventory change. Taking advantage of a Treasury Decision, taxpayer retroactively elected to limit its previous election of LIFO to raw materials only. This change resulted in overpayments for years which were closed under the statute of limitations, and a deficiency for a year still open. The court holds that there was neither an erroneous inclusion in income in the closed years nor an inconsistent position on the part of the Commissioner, necessary ingredients for the applicability of 1939 Code Section 3801. *Dubuque Packing Co.,* CA-8, 4/27/56.

Payment of proposed deficiency doesn't start statute running. Taxpayer transmitted a check to the Director of Internal Revenue to cover a proposed deficiency as shown by a revenue agent's proposed adjustments. Since no assessment had been made, the payment was placed in a "suspense account." The assessment was made almost three years later, pursuant to a waiver executed by taxpayer. For purposes of the timeliness of a claim for refund, the court holds that a money transfer to a federal tax authority does not become a "payment" until the tax obligation becomes defined by virtue of an assessment. Accordingly, a claim filed more than two years after the transfer of the funds, but within two years of the assessment, was timely. *Dubuque Packing Co.,* CA-8, 4/27/56.

Consent to extend statute of limitations recognized. In a prior opinion the court held that the statute of limitations would bar a 1948 assessment made in February 1953 unless it was shown that taxpayer omitted more than 25% of his reported gross income. On motion to reopen the record, the court now holds that the statute of limitations had not expired at the time of the assessment; there was introduced in evidence a signed consent extending the statute to June 30, 1953. *Hulshart,* TCM 1956-85.

Time to elect foreign tax credit or deduction not extended by loss carryback. The election of a taxpayer to claim credit against U. S. tax for foreign taxes paid may be made or changed prior to the expiration of the normal limitation period. The special period of limitations with respect to filing a refund claim based on a net operating loss carryback has no application. Thus a taxpayer who elected a credit on its 1947 return cannot change in filing a claim for refund due to operating loss carryback. The claim, though within the extended period for filing allowed because of the carryback, was not filed within the normal period. *Rev. Rul.* 56-196.

Tax Court order dismissing a pleading held appealable. In a Section 722 case the Tax Court, by order, struck an amendment to the Commissioner's answer. The taxpayer moved to dismiss the appeal from this order as not being from a "decision" of the Tax Court. The court holds that since the order finally disposed of the proceeding, it amounted to a decision. *Seminole,* CA-5, 5/8/56.

Taxpayer destroyed records; no expenses allowed. Taxpayer, a bookmaker, deliberately destroyed his records because they would be evidence of his illegal activity. The Tax Court found that other proof of expenses was flimsy, and the credibility of the taxpayer was questionable. It refused to apply the *Cohan* rule. This court affirms. *Nellis,* CA-6, 4/14/56.

Beneficiary must pay decedent's tax liens to extent of CSV when attached. [*Certiorari denied*] Taxpayer's husband died in 1949 owing federal income taxes for which assessment and demands for payment had been made. Because of this action there were tax liens against his seven insurance policies, of which taxpayer was beneficiary. The estate was insolvent. The husband had the power to change the beneficiary, to borrow upon the policies, and to collect their surrender value. The Commissioner contended that he could collect the asssessed deficiencies out of the proceeds of the policies to the extent of their cash-surrender value when the liens attached. The Second Circuit agreed, distinguishing *Rowen* (215 F.2d 641), because it was not brought out in that case that a tax lien had been created prior to the insured's death. In *Rowen,* this circuit held the beneficiary did not have to pay the decedent's income tax because under New York law she received the insurance proceeds free of all claims and a liability under state law was a precondition for federal transferee liability. In this case, a lien existed against the surrender value of the husband's death. Realistically, the surrender value survived the death and became part of the proceeds of the insurance. On that assumption, the lien which was enforceable against the surrender value became a charge on the proceeds of the policies. *Behrens, cert. den.* 4/30/56.

IRS can't back out of stipulation. The court refused to grant the Commissioner's motion to withdraw a stipulation of settlement. He failed to show that his representatives made a mistake in filing the stipulation or were unaware of the points which he now wished to press. The Commissioner had argued that statements in an affidavit filed by taxpayer falsely represented that taxpayer was not a "primary obligor" of a certain corporate note. The court, however, held that the affidavit did properly refer to taxpayer as an accommodation-maker and as such did not mislead the IRS. *Saigh, Jr.,* 26 TC No. 18.

Commissioner can waive filing of Form 843. Taxpayer-corporation timely filed a Form 991 claim for Section 722 excess-profits-tax relief. The claim failed to mention two standard-issue adjustments which were considered on the merits by the Commissioner and resolved in taxpayer's favor. The Commissioner having been aware of, having considered, and having acted on the merits of the standard-issue adjustments, effectively waived the requirement that a refund claim must specify the grounds relied upon for relief. This requirement is not statutory (*i.e.,* binding on taxpayer and Commissioner alike); it is regulatory and may be waived by the Commissioner. *Martin Weiner Corp.,* 26 TC No. 13.

Assignee must file timely return for debtor. An assignee for the benefit of creditors may be assessed a delinquency penalty for late filing of the debtor's return due after the assignment. *Rev. Rul.* 56-158.

Interest on taxes accrues after filing bankruptcy petition. Interest accrues on a deficiency in tax for the period during which the affairs of a taxpayer are being administered by the bankruptcy court and may be properly offset against any refund due the taxpayer. *Rev. Rul.* 56-162.

MANAGEMENT OF THE

Professional tax practice

AND PROFESSIONAL AFFAIRS OF LAWYERS & ACCOUNTANTS

AIA's Carey holds Treasury interpretation protects CPAs in Treasury practice

RECENT DOUBTS expressed on the extent to which the Treasury Department's January 30 interpretation of Circular 230 protects the position of CPAs in practice before the Treasury Department have prompted John L. Carey, executive director of the American Institute of Accountants, the national society of CPAs, to write the following comment for publication in THE JOURNAL OF TAXATION. Mr. Carey says this:

In your April and May issues you have published Reuben Clark's doubts about the effectiveness of the Treasury Department interpretation of Circular 230, dated January 30, 1956.

These doubts, in my opinion, are not well founded, but unless they are cleared up they may make more difficult the task of those who are trying to revive a spirit of cooperation between lawyers and certified public accountants in tax practice. These comments are offered in the hope that they may dispel confusion.

Since I participated in the discussions with officials of the Treasury Department which preceded the issuance of the interpretation of January 30, I think I understand what the Treasury Department intended to do, and did do.

Lawyers' support welcomed

First let me say that we welcome Mr. Clark's support of the position of certified public accountants in Treasury practice. It is most encouraging to find him in company with other distinguished tax lawyers, such as Dean Griswold and Paul Jackson of the Texas bar, in accepting as proper the customary practice of enrolled certified public accountants before the Treasury Department. It is Mr. Clark's concern lest this practice be jeopardized that leads him to question the effectiveness of the Treasury interpretation of January 30. Since I am naturally wholly in sympathy with his motives, I do not wish it to appear that there is anything unfriendly in this effort to demonstrate that there is really no basis for his concern.

The "ethics" question

The only question at issue arises from the last two paragraphs of the Treasury interpretation, which refer to the professional responsibility of enrolled persons, as an "ethical" requirement, to determine when the assistance of a member of another profession is required, in accordance with the "Statement of Principles."

The question is whether these last two paragraphs leave a loophole through which state courts can assume jurisdiction over the activities of certified public accountants in practice before the Treasury Department, in spite of the fact that the first six paragraphs of the interpretation clearly "preempt" the field of practice before the Treasury Department as within the exclusive jurisdiction of the Federal Government.

Mr. Clark fears that there is such a loophole. Mathias Correa, counsel for the American Institute of Accountants, says quite firmly that there is not (see 4 JTAX 219).

There must be a misunderstanding.

I think the root of the misunderstanding is laid bare in the following statement from Mr. Clark's article in your May issue:

"The courts have long been free to discipline lawyers for unethical acts committed wholly before federal courts; it seems clear that they can continue to discipline enrolled lawyers *or accountants* for unethical conduct consisting of a failure to call in the other when required." (Emphasis supplied)

The courts have never had the power to discipline certified public accountants for unethical conduct. This is the function of the state boards of accountancy. The only way in which the courts can interfere with the activities of accountants is to hold such activities to be "unauthorized practice of law."

But the courts cannot hold activities involved in practice before the Treasury Department by an enrolled agent to be the "unauthorized practice of law," because the Department, exercising the power given it by Congress, has "preempted" this field.

Once it is understood that the courts cannot interfere with enrolled agents on ethical grounds, the Treasury Department's interpretation of Circular 230 is clear and consistent throughout. What it says, in effect, is this:

1. Congress has given the Treasury Department the responsibility of regulating practice before the Department.

2. The past practice has been highly satisfactory.

3. It is the intention of the Department that all persons enrolled to practice before it be permitted to *fully* represent their clients before the Department.

4. Decisions of state courts and other statements have suggested varying interpretations of that part of the Treasury's regulations which state that persons not members of the bar are not authorized by the Treasury Department to "practice law."

5. A *uniform* interpretation and administration of this and all the other regulations are essential to proper discharge of the Treasury Department's responsibility imposed on it by Congress.

6. It is *not* the intention of the Department that the proviso in the regulations regarding the "practice of law" should be interpreted as an election by the Department not to exercise fully its responsibility to determine the proper scope of practice by enrolled agents and enrolled attorneys before the Department. (The California court in the *Agran* case did interpret this proviso in the way the Secretary now says is not the Department's intention.)

7. However, *the Department* holds enrolled agents and enrolled attorneys responsible for determining when the assistance of a member of the other profession is required. (Presumably, although it authorizes enrolled certified public accountants to "fully represent their clients" before it, the Treasury Department does not wish to encourage them, for example, to express an opinion on the validity of trust instruments,

nor presumably does it wish to encourage enrolled attorneys, for example, to prepare financial statements or deal with complex accounting problems with which they are not competent to deal.)

8. The Department places this responsibility on its enrolled agents and enrolled attorneys as an *ethical* responsibility, *not as a legal restraint.* In this connection the interpretation refers to Section 10.2(z) of Circular 230, which spells out the ethical responsibilities of enrolled persons. (This section, like all other sections of Circular 230, has been and obviously will continue to be *administered and enforced by the Treasury Department itself, not by the courts.*)

9. As a guide to enrolled persons in discharging this ethical responsibility, the Treasury statement refers to the "Joint Statement of Principles Relating to Practice in the Field of Federal Income Taxation," which was approved by the House of Delegates of the American Bar Association and the Council of the American Institute of Accountants in the year 1951. (This reference, however, does not give the Joint Statement any *legal* effect. The Treasury Department might, if it wished, have referred to articles by Dean Griswold or Maurice Stans, or other leaders of the two professions, as an appropriate guide to discharge of the ethical responsibility which the Treasury Department has imposed on its practitioners.)

10. The Treasury Department will keep watch over the behavior of enrolled practitioners, and if enrolled agents and enrolled attorneys do not respect the appropriate fields of each, as indicated by the Joint Statement, *the Treasury Department* will review the matter to determine whether it is necessary to amend the Circular or take other appropriate action. (It is clear that the Treasury Department will do whatever disciplining and defining needs to be done. There is no invitation here for the state courts to enter the field.)

Mr. Clark is puzzled as to the connection between ethics and the responsibility for determining when the assistance of a member of another profession is required. It seems to me implicit in the concept of professional ethics that a practitioner should not venture beyond the bounds of his own professional competence. In *Legal Ethics,* by Henry Drinker*, the following appears:

"A lawyer should not presume to undertake professional employment for which he is not reasonably competent, but should recommend or at least associate a specialist."

"Should I not understand my clients' cause after due means to comprehend it, I will retain it no longer, but honestly confess it, and advise him to consult others, whose knowledge of the particular case may probably be better than my own." (Hoffmans' "Fifty Resolutions in Regard to Professional Deportment")

The application of this ethical principle of competence is inevitably subjective. For this reason it cannot be enforced legally. That is why the Treasury Department "has properly placed *on its enrolled agents and enrolled attorneys* the responsibility of determining when the assistance of a member of the other profession is required."

The Treasury Department can, and perhaps will, discipline enrolled agents and enrolled attorneys for venturing beyond the fields of their professional competence, but it has not delegated to anyone else its authority to do so.

Implicit in the interpretation is an invitation to the American Bar Association and the American Institute of Accountants to get together and develop "ground rules" less ambiguous than the Statement of Principles, to serve as guides to their members in observing the ethical responsibility of keeping within the bounds of their professional competence.

On April 23, 1956, committees of the Bar Association and the Institute met to plan the first steps toward the attainment of this objective. This will encourage the vast numbers of men of goodwill in both professions who earnestly seek an end to turmoil in tax practice.

In the long run, the solution of the "lawyer-accountant controversy" will come from the desire of individual lawyers and individual certified public accountants throughout the country to live together in peace, and work together in harmony, for the best interests of taxpayers and government.

In preserving the legal "status quo ante *Agran*" in practice before the Treasury Department, while at the same time encouraging the two professions to work out their mutual problems in a framework of ethical responsibility, the able lawyers in the Treasury Department have done a job which is not only supremely skillful technically, but is a masterpiece of statesmanship. ☆

*Legal Ethics, by Henry S. Drinker, Columbia University Press, 1953, page 139, page 342.

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TAX ASPECTS OF ESTATE PLANNING

Estate & gift taxation

OF INTEREST TO TAX PRACTIONERS

How proposed Regulations affect taxation of insurance transfers and death benefits

by WALTER D. FREYBURGER

THE 1954 CODE, like the 1939 Code, limits the amount of proceeds excluded from gross income in the case of a life-insurance contract that had been transferred for value. The amount excluded from gross income paid because of the death of the insured cannot exceed the sum of the actual value of the consideration and the premiums subsequently paid by the transferee.

The 1954 Code added a provision exempting from the transfer-for-value rule transfers to the insured, a partner of the insured, a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.

In the case of multiple transfers, it had been held under the 1939 Code that even though there was no transfer for value to the last transferee, nevertheless if there had been a transfer to the last transferor for a valuable consideration, then the last transferee stood in the same position as the last transferor, and the exemption of the proceeds would be limited.[1] It was also held that if the transfer was made in a tax-free reorganization, such as a merger, the proceeds would not be exempt when paid to the last transferee if they would not have been exempt if paid to the transferor. It was held that the transferee stood in the shoes of the transferor.[2]

These decisions were also strengthened by the income-tax Regulations[3] and by the Senate committee report relating to the Revenue Act of 1942.[4] The proposed Regulations follow these decisions and the previous position of the Service, except where there is a transfer to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer. In these cases, the service holds that the fact that there had been a prior transfer for value is immaterial.

Exception to the rule

As far as the language in the 1954 Code is concerned, transfers made in a tax-free reorganization constitute an exception to the transfer-for-value rule to the same extent as a transfer to an insured or to a partner or to a partnership. However, apparently the Service feels that since the old law was so construed as to make a transferee stand in the shoes of the transferor, and since the old law was reenacted, the Regulations should follow the old construction. On the other hand, since there is nothing in the committee reports to indicate that transfers to an insured, to a partner, to a partnership, or to a corporation of which the insured is a shareholder or officer shall cause the transferee to stand in the shoes of the transferor, the general rule relating to multiple transfers is not applied to these new exemptions.

It may be argued that the same position should be taken in all of these multiple transfers, and since the law expressly provides that the transfer-for-value rule shall not apply to all these various exceptions, the committee report on the 1939 Code should not be given any weight. On the other hand, the Treasury might have taken the position that the old rule with respect to multiple transfers should apply to all the exceptions made under the 1954 Code.

Employees' death benefits

The 1954 Code excludes from gross income aggregate amounts received by the beneficiaries of the estate of an employee up to $5,000 paid by an employer or employers because of the death of the employee. However, this exclusion does not apply to amounts with respect to which the employee possesses, immediately before his death, a nonforfeitable right to receive the amounts while living. [Note that this nonforfeitable rule, however, does not apply to amounts paid under an approved employees' plan and paid within one taxable year of the distributee by reason of the employee's death.] The question arises as to what constitutes a "nonforfeitable right."

The Regulations, through various examples, take the position that an employee has a nonforfeitable right even if he could lose such right by voluntary action on his part, such as leaving his employment. On the other hand, if the employer can be relieved of his obligation by discharging the employee then the employee has a forfeitable right.

Most laymen would conclude that an employee has a forfeitable right if he will lose it in case he voluntarily leaves his employment. To say he has a nonforfeitable right, although his right would be lost if for any reason he leaves his employment, seems unrealistic. In addition, this definition of nonforfeitable is inconsistent with that used in other parts of the 1954 Regulations.

Subsection (b) in Section 101 of the 1954 Code, relating to employees' death benefits, is derived from and "parallels Section 22(b)(1)(B) of the 1939 Code" (see reports on H.R. 8300 by House Ways and Means Committee, at page A29, and Senate Finance Committee, at page 180), but adds certain special rules. Neither Section 101(b) of the 1954 Code, nor the Regulations under Section 22(b)(1)(B) of the 1939 Code, contain a definition of the term "nonforfeitable" as used therein. However, the old Regulations, in providing that the $5,000 "exclusion does not apply to amounts with respect to which the deceased employee possessed, immediately prior to his death, a *nonforfeitable* right

to receive the amounts while living" specifically refer to Section 39.165-7 of the old Regulations [Reg. 118, Section 39.22(b)(1)-2(d)(1)]. Paragraph (a) in Section 39.165-7 of the old Regulations (Reg. 118) provides that an "employee's beneficial interest . . . is nonforfeitable . . . if there is no contingency . . . which may cause the employee to lose his rights . . . For example, if under the terms of a pension plan, an employee upon termination of his services prior to the retirement date, *whether voluntarily or involuntarily*, is entitled to a deferred annuity . . . the employee's beneficial interest . . . is nonforfeitable." The same definition of the term "nonforfeitable" is contained in Section 1.402(b)-1(a)(2)(i) of the proposed Regulations on qualified pension, profit-sharing, and stock-bonus plans, under Sections 401 to 404 of the 1954 Code.

Payment later than death

Under Section 101(d), where payment of life insurance proceeds is made at a date later than death the general rule is that there will be excluded from the income tax only the amounts held by an insurer, and if such amounts are paid in installments they shall be prorated. The amount held by an insurer is generally the amount that would have been payable in a lump sum had the contract not provided for payments in installments. It is the amount that is exempt from income taxes, since it is considered the amount paid by reason of the death of the insured. In other words, it represents capital, or the cost of the contract. Gross income includes any amounts paid which are not excluded on account of constituting part of the amounts held at the time of the death of the injured. One of the principal questions in connection with this section relates to the treatment of an optional mode of settlement which contains a refund feature. Subparagraph (c)(1) states that "in *every* case in which the contract provides for an option to take the proceeds of the policy in a lump sum at the time of the insured's death . . . such lump sum shall be considered the 'amount held by an insurer.'" It then provides that the lump-sum figure shall be divided by the fixed period or the life expectancy of the beneficiary, as the case may be, to determine the annual exclusion from gross income. This calculation ignores any refund feature if the policy contains an option to take the proceeds in a lump sum. Often the contract provides that installments shall be paid during the life of the beneficiary, but for not less than 10 years or some other specified period. If the beneficiary dies during the guaranteed period, the balance of the guaranteed installments is paid to a contingent beneficiary named in the contract. Payments to the second beneficiary are in the nature of a refund, arising on account of the early death of the first beneficiary.

However, subparagraph (c)(2) of the same paragraph provides that "if the 'amount held by an insurer' with respect to a beneficiary cannot be determined except by reference to the beneficiary's life expectancy, the value of any refund feature to a subsequent beneficiary or the estate of the insured shall be disregarded in determining the 'amount held by an insurer'. Such refund, when received, is excludible from the income of the recipient." It is not entirely clear as to what is meant by the phrase "the value of any refund feature *** shall be disregarded." In determining the "amount held by an insurer" which is considered the cost of the contract, must the value of any refund feature be deducted from the cost, or will the value of the refund be "disregarded," and the amount held by the insured be considered the total amount that would have been payable in a lump sum had the contract not provided for payments in installments?

The treatment of a refund feature should be consistent whether the lump sum which could have been taken is regarded as the amount held by the insurer or whether the amount held by the insurer is determined by computation based on mortality and interest.

There does not appear to be any authority in the statute for adjustment of the amount held by the insurer under Section 101 because of a refund feature in the optional settlement. However, the Senate Finance Committee Report does contain the following language:

"If the mode of settlement contains refund features the yearly exclusion will be computed under regulations to be prescribed by the Secretary or his delegate, after excluding an actuarial value of such features."

In spite of the Senate committee report and in view of the language of the statute, it would appear that the Secretary would not be authorized to reduce the amount held by the insurer by the value of any refund feature. There is no provision in Section 101 requiring adjustment in amounts held by the insurer, as there is in Section 72(c)(2), requiring an adjustment in investment where there is a refund feature in an annuity contract.

Treatment of options

The proposed Regulations do not specifically cover the very common "fixed amount" or "pay until exhausted" option under which the proceeds, together with interest credited periodically, are distributed over a period of years in installments of a fixed amount. There is a need for an authoritative rule for the treatment of this option. It is suggested that it be treated as the equivalent of a "fixed period" option,[5] the period being determined by the guaranteed interest. Any excess interest over the guaranteed amount of interest which is added to the fund, and which has the effect of extending the period for which installments are to be paid, should be fully taxable when paid in the form of extended installments, subject to the $1,000 exemption allowable to the surviving spouse.

Section 101(d)(2) provides that the "amount held by an insurer" is the amount held by the insurer "under an agreement provided for in the life insurance contract." Almost every life insurance company offers special options or combination of options to all policyholders which are not specifically set forth in the policy. For example, one prominent insurance company gives all beneficiaries (in the event the insured has not elected an option) the right to elect to take up to two years to make the election of a final option and during the two year period the insurer pays interest on the life insurance proceeds. This option is very popular and is socially very desirable because it gives the widow a breathing period after the death of her husband in which to fully consider the various options. The insurance laws of the State of New York which prohibit the New York Life Insurance Company (organized under New York law) from discriminating in favor of any class of policyholders or beneficiaries make it quite clear that this combination of options is and must be

[1] *Alcy S. Hacker*, 36 BTA 659 (1937).
[2] *James F. Waters, Inc.*, 160 F. 2d 596 (Ninth Circuit, 1947).
[3] Reg. 103, Sec. 1922; Reg. 118, Sec. 39(b)(2)-3.
[4] 1942 CB 558, in which it is stated: "Thus, where a corporation transfers an insurance policy to a successor corporation in a tax-free reorganization, the proceeds received under the policy will be exempt from taxation when received by the transferee if they would have been exempt if received by the transferor."
[5] *Mary C. Heyser*, 3 TCM 582 (1944).

[*Mr. Freyburger, an attorney, is tax counsel to New York Life Insurance Company.*]

made available to all beneficiaries, if available to any beneficiary of a policyholder at the time of the death of the insured. Inasmuch as the policy is issued subject to the state insurance law, it would seem that the combination of options is part of the insurance contract enforceable by the beneficiary, even though not specifically set forth in the policy itself.

Family income policies

Section 1.101-4(b)(3) provides that in the case of an insurance policy which has no provision for the payment of a lump sum immediately upon the death of the insured, the sum ascertained by discounting the amount of the proceeds of the policy to the date of the insured's death on the basis of the interest rate used by the insurer shall be the "amount held by the insurer." While this language would literally apply to the family-income settlement arrangement under which relatively small periodic installments are payable for a fixed or determinable period and under which the face amount of insurance is not paid until the end of such period, it is clear that this treatment is not appropriate for the family-income benefit. It has been suggested that the intent of the law requires that the final lump-sum payment representing the face amount be entirely exempt and that an annual exclusion for the periodic payments be determined on the basis of the value of the periodic payments as of the date of the insured's death. This suggestion may not be the best approach in all cases. However, the family income benefit is sufficiently common to justify specific treatment in the Regulations. ☆

New estate & gift decisions this month

by Theodore Berger

No marital deduction for trust despite wife's power to invade. Decedent's will created a trust with income payable to decedent's wife for life. The wife was also given the power to invade the corpus if income should be insufficient, and she was the sole judge of its sufficiency. Taxpayer-estate contended that this was the equivalent of a trust subject to a general power appointment in the wife and thus qualified for the marital deduction. The court holds that the power of invasion is not the same in law as a power of appointment, and further suggests that the power to invade is limited to the case where the wife determines in good faith that the income is insufficient. Moreover the trust fails to meet the specific statutory requirements. *Markham Estate (Matteson, Exec.)*, DC NY, 2/29/56.

Diplomacy is not a business. An ambassador or other diplomatic officer of a foreign country duly accredited to the U. S. is not considered for estate-tax purposes as having been engaged in business in the U. S. at the time of his death solely by reason of his diplomatic activities. *Rev. Rul.* 56-52.

Provision for wife held a separate trust; marital deduction allowed (old law). Decedent gave his wife a 40% interest in the trust created out of his residuary estate, with a power of appointment. Because of the differing provisions governing the various remainder interests, the court was able to find this 40% interest constituted a separate trust and thus qualified for the marital deduction. [Under the 1954 Code, a defined portion of a single trust would be qualify for the marital deduction, eliminating the problem posed in this case. *Ed.*] On another issue, the court found the value of real property owned by the decedent on which the tenants had made improvements. *Barry Estate*, TCM 1956-97, 4/27/56.

Reciprocal trusts not crossed in absence of evidence of other consideration. Decedent and his wife on the same day each created a trust of which the other was income beneficiary for life, with remainder to one of their children; the trusts received identical property and their terms were substantially the same. To include the trust of which he was beneficiary in decedent's gross estate, the Commissioner would have to show he was in fact the settlor of the trust, although his wife was nominally the settlor. Other courts have reached this result by finding that decedent's creating a trust for his wife was the consideration for her creating a trust for his benefit. But this court refused to make such a finding in the absence of any direct evidence of consideration. One dissent: "Here is a beneficial interest contemporaneously bestowed upon the maker of each trust, by the maker of the other trust. The significance of this circumstance has been overlooked by the majority opinion. It is an undue taxing of our credulity to ask us to believe that this transaction lacked consideration. The only logical inference to be drawn from the stipulated facts is that . . . the act of one was the consideration for the act of the other." *McLain*, CA-7, 4/17/56.

Full amount of unusually large executor's commission allowed. Pursuant to the directions contained in a letter from the decedent, the estate paid the executor a 5% commission, which is in excess of the usual rate. The Orphan's Court of Pennsylvania authorized the payment, but for unexplained reasons only about half this amount was allowed in computing the Pennsylvania inheritance tax. Nevertheless, this court allowed the full amount authorized and paid as a federal estate-tax deduction. A deduction was also allowed for the full amount of a bequest in trust for the care of a family plot in a church cemetery: part of the bequest was a funeral expense and part a contribution to a religious organization. Finally, the court allowed a bequest in trust to the Philadelphia Bar Association for the preservation of books in its law library. While the library was used by practicing lawyers, it also served a public purpose and aided scholarship. *Audenreid Estate*, 26 TC No. 12.

Pre-1932 transfer includible; decedent retained some right to income for life. Decedent's husband was obligated to pay his first wife $9,000 a year and he established a trust for this purpose. When he died, decedent (his second

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wife) became entitled to the property subject to the first wife's rights. In January 1932 she transferred her interests to another trust in which she reserved the income rights but irrevocably disposed of the remainder. Such a transfer, if made today, would in any event be includible in the gross estate as a transfer with income retained for a period not ascertainable without reference to decedent's death. The court held it was likewise includible under the law applicable to transfers between March 3, 1931, and June 7, 1932, because of the retained right to receive income in excess of $9,000 a year for life, although in fact there was no income in excess of $9,000 in any year.

On another issue, the court allowed executor's commissions computed under Alabama law and thus based upon income received during administration. The commissions in total represented the usual fee for administration of the estate and were not an expense of any business conducted by the estate. *Hubbard Estate,* 26 TC No. 19.

Full amount of administration expenses allowed in community-property estate. The general rule is that only the administration expenses applicable to decedent's half of the community property are deductible. But here, although the property subject to Louisiana community property laws consisted of oil and other interests worth over $10,000,000, it was shown that no administration of the community property would have been necessary except to facilitate the computation of state and federal death taxes. Under these circumstances, the entire amount of administration expenses can be deducted as allocable to the decedent's share. *Helis Estate,* 26 TC No. 15.

Land subject to zoning restrictions valued at its cost. A trust owned land which was restricted for residential purposes. After an unsuccessful attempt to have it rezoned, it sold the property to taxpayer in April 1950. In December of that year taxpayer deeded most of the property to his town for public purposes. The court determined that the gift should be valued at the price paid by the taxpayer, that being the best evidence of its fair market value. *Dresser,* TCM 1956-54.

Wife's services as business partner converted homestead to business property; marital deduction allowed. During his life decedent had transferred a citrus grove to himself and his wife as tenants-by-the-entireties under Florida law. To show that the wife inherited the property as complete owner and did not receive merely a life estate in the homestead, the estate must establish consideration for the wife's receiving this interest. Consideration is found from the wife's services as a partner in the operation of this grove; the wife kept books and took orders, which were activities not usually connected with just a homestead. The estate therefore is entitled to the marital deduction on this property. *Nelson Estate,* CA-5, 4/25/56.

Entireties property separated in contemplation of death; husband's estate includes only his half. [*Acquiescence*] Decedent and his wife held as tenants by the entireties securities which had all been purchased with decedent's own funds. In 1945, by a transfer in contemplation of decedent's death (which occurred in 1947), they each took half as separate property. Of course the decedent's half is includible in this estate. The Tax Court agrees that the other half is not. Each tenant by the entirely may be considered as owning half. No more should be included now merely because of the transfer in contemplation of death. *Carnall Estate,* 25 TC No. 78, *acq.* IRB 1956-17.

IT TAKES MORE MONEY TO STAY EVEN

CONSIDERING the increase in personal and corporate income taxes and inflation, an individual now has to earn three or four times as much today as he did in 1939 just to "stay even". Our esteemed fellow-editor Peter Dirr sends us this note, based on a calculation by the Western Tax Council. The first column is 1939 salary, the second is the 1956 salary needed to "stay even":

$ 1200	$ 2364
1800	3840
2500	5612
3000	6986
4000	9467
5000	12,050
7500	19,029
10,000	26,435
15,000	46,174
25,000	99,136

New trusts & estates decisions

Family partnership income taxed to grantors, not trusts; trust taxable on interest refund. [*Certiorari denied*] The grantors transferred half their business to taxpayer-trusts, the beneficiaries of which were the grantors' children. The trusts received, and paid taxes on, half the income of the business. The Tax Court held that all the business income was taxable to the grantors. The overpayment by the trusts was credited against the grantors' deficiencies. Interest on the trusts' overpayment was paid directly to the trusts with no offsetting deduction. One dissent on the ground that the grantors never intended to give the trusts tax-free income. It was proper for the trusts to consent to the offset of the refunds. Likewise, the trusts would be unjustly enriched if they retained the interest; they were mere conduits for it. *Easley Trusts, cert. den.* 5/7/56.

Trust income taxable to grantor; could be paid to him at discretion of non-adverse trustees. A 21-year old taxpayer created an irrevocable trust to accumulate income for himself until he reached 35. Should he die before reaching 35 without wife or issue surviving him (he had a wife and child), the accumulated income was to go to his mother and father, co-trustees with a bank. The trustees could in their absolute and uncontrolled discretion distribute income to the grantor without limit. The court finds the case covered by Section 167 of the 1939 Code, taxing the grantor on income distributable to him in the discretion of a person without substantial adverse interest. On these facts the court holds the trustees' interest in the remainder was too remote to be substantial. *Barker,* 25 TC No. 142.

Trust allocation of depletion need not follow income from depletable assets. If the manner in which the deduction for depletion may be apportioned between the income beneficiaries and the trust corpus is within the sole discretion of the trustees, then they may properly allocate all of the depletion deduction to the beneficiaries although a substantial portion of the income from same is retained by the trust. *Rev. Rul.* 56-105.

NEW DEVELOPMENTS IN

Foreign aspects of taxation

EDITED BY SIDNEY I. ROBERTS, LL.B., CPA, JOHN COSTELLOE, LL.B., AND JOHN WILCOX, LL.B.

Canadian tax revision ahead of United States; many long-sought changes adopted

PERSPECTIVE on the rate of development of the United States tax structure may be gained from a comparison, by J. Harvey Perry, Director of the Canadian Tax Foundation, of trends of statutory revision in the United States and in Canada. In the remarks set forth below, Mr. Perry points with pride to the evidence of greater maturity in the Canadian tax system. Particularly impressive is the prompt and orderly manner of the revision undertaken in Canada. Our hasty wholesale revision, which has resulted and will continue to result in much confusion and uncertainty, suffers by comparison. The basis for the contrast may be suggested: Canada seems to have been more successful in divorcing the technical aspects of its tax system from political pressures. Mr. Perry says this (in III *Canadian Tax Journal* No. 3):

Everybody—and I do mean everybody—must know by now that the U.S. Internal Revenue Code underwent a major revision in 1954. This revision has provided an apparently inexhaustible source of new material for tax articles and speeches. In fact, I have even heard speeches by prominent American officials which left little doubt that the new Code was about all that stood between the free world and the Red menace. This is all very well and being good neighbours we would not detract in any way from the importance of this long-overdue event. But we for our part take justifiable pride in the fact that we started an overhaul of our income tax law immediately after the war, took about three years in working it out and have now had it in effect for over six. What is even more important is that the really major changes in the new U.S. Code were based on the Canadian revision. I refer to diminishing-balance depreciation and the dividend-tax credit. There were lesser borrowings too, but these were the most conspicuous.

Canadian revision procedure

This challenging statement calls for some elaboration. The original Canadian income tax statute—the Income War Tax Act—was introduced in 1917 as an emergency measure. It had some basic organization at the outset, but the depression and World War II turned it into a shambles, and by 1946 everyone agreed that it badly needed overhauling. The Canadian Senate held some public hearings which stimulated interest, and government followed up with the appointment of an inter-departmental committee to work out a new law. A draft was introduced in Parliament in 1947 and was allowed to stand over for a whole year for public examination. Briefs were submitted by almost all interested organizations, the final bill was passed at the 1948 session and the new law—the Income Tax Act—came into effect on January first, 1949. This important measure either introduced or gave permanent form to several major revisions in our income tax system.

In the broadest sense its effect has been to give us a great deal more statute law than we have ever had before. Many important matters formerly left to the administration to settle by the exercise of discretion are now spelled out in the establishment of our first lower court of tax appeal—the Income Tax Appeal statute. This was accomplished by the Board—which is inexpensive and produces fast decisions. One very definite trend under the revision therefore has been towards both more statute law and more jurisprudence, and in this respect we are definitely moving closer to the American pattern.

Of the changes which are most directly affected the calculation of taxable business income undoubtedly the most sweeping was the abandonment of the traditional scheme of depreciation allowances and the introduction of a whole new concept of allowances for "capital costs". The philosophical implications of this new system involved almost completely discarding the "wear and tear" basis of depreciation of physical assets and adopting in its place the principle that certain expenditures are too large to write off in one year and are therefore spread over some reasonable perod of time in order to avoid undue distortion of the income statement. In practice the capital cost allowances system has meant three main changes: (1) the approximate doubling of the rates of write-off with these higher rates applying on a diminishing balance rather than a stranght-line basis. These rates it might be added only serve as a ceiling, since the taxpayer can take anything less if he wishes. (2) The grouping of assets into a dozen or so main classes, with the rate of write-off applying to the balance remaining in each class at the end of the year after adding new acquisitions and deducting recoveries from the sales of old; and (3) a system for recapture of write-offs in the event of a sale of a whole class of assets at a price in excess of written-down value. In no case where recoveries enter the calculation is there any recapture in excess of original cost—in short "capital gains" are not included in the recovery. This is a very crude summation of this system, as I'm sure my accounting friends will agree, but it is enough to give the general idea.

Accountants are concerned

The scheme thus loosely described came into effect in 1949, and has been the source of contention among accountants until last year. The irritation arose not so much with the scheme itself but with the requirement that capital cost allowances taken for income tax purposes be the same as those taken on the books of the company. Since many accountants felt the capital cost rates were unreal they disliked being tied to them for all purposes, but this restriction was removed last year and now everyone seems reasonably satisfied.

So much then for trends in depreciation allowances in Canada. I know I am safe in saying that the Treasury officials

in Washington were not unaware that a system involving doubled rates and the diminishing-balance system had been in effect for some five years in Canada when they proposed it for the new Code. This is as close as I will venture in claiming Canadian parentage for this child.

Dividend tax credit

The other big headline attraction in the Code revision was the dividend tax credit. The American version of this very successful Canadian presentation so nearly flopped that we should have withdrawn the performing rights. In Canada the dividend tax credit was only one feature of a well-rounded programme of innovations connected with company-shareholder taxation. The first step came in 1949, when the existing 30 per cent corporate rate was replaced by two brackets of 10 per cent on the first $10,000 and 33 per cent on the excess. Concurrently a 10 per cent dividend tax credit was introduced, which had the effect of removing the double taxation of small businesses and of alleviating it considerably for all other businesses. The strangest aspect of all this is that we have nothing in Canada comparable to the American small-business movement. Subsequent increases in the corporate rate made without corresponding increases in the dividend credit destroyed this symmetry, but it was restored in 1954 when the dividend credit was increased to 20 per cent, the same level as the lower bracket rate.

This relief for the shareholder receiving current dividends was paralleled by an equally enlightened innovation for the shareholders of companies having large undistributed surpluses on hand. In 1950 a measure was introduced under which a company can pay a tax of 15 per cent on its undistributed income on hand in 1949, capitalize this amount by the issuance of preferred shares or stock dividends, and later redeem these with no further tax to the shareholder. For earnings since 1949 there is sort of an incentive plan, under which a company can capitalize an amount of undistributed earnings equal to the amount of dividends it has declared.

There are other aspects of this development that could be mentioned but I have said enough to give you the general idea. The American exclusion of the first $50 of dividend income and the 4 per cent tax credit is, it will be seen, a well watered down version of the 20 per cent tax credit granted in Canada.

Lifo inventory method

In another phase of business taxation the contrasts between the two countries have been just as marked as the similarities I have just discussed. In both countries some very marked strides have been made in recent years in closing what is commonly known as the gap between business income and taxable income. However, in two very important areas developments have followed widely separated courses and have produced quite different results. The first of these is the all-important question of inventory valuation. In the United States tax men were able some time ago to convince the authorities that LIFO was an essential element in a proper calculation of business profits, and the tax laws were amended accordingly. If one hears any comment on the matter now it is to the effect that LIFO has been pushed too far, rather than that it has been held back. By contrast the tax authorities in Canada, despite an attitude on depreciation that is extremely liberal-minded compared to that of the U.S. Treasury, have been adamant in their opposition to LIFO. In fact, the administration recently made itself quite unpopular by appealing to the Privy Council in England a judgment of our own Supreme Court in which the Anaconda Company had been granted the right to use LIFO for tax purposes. The judgment in this case will have significance for many other taxpayers. If LIFO should ever become an accepted basis of inventory valuation it will be in spite of every effort of the administration to block it. [The Privy Council has since ruled against LIFO. See discussion of the case here next month. *Ed.*]

Prepaid income

An equally interesting contrast can be drawn in connection with the treatment of reserves for prepaid receipts and postponed expenditures. In Canada two or three years ago we had court decisions which declared that many reserves that had been permitted for years were not allowable under the revised act. The federal Minister of Finance, although no doubt momentarily happy with this result, nevertheless proposed to Parliament amendments which in effect restored the previous position. I will overlook the fact that many Canadian accountants are unhappy that certain basic accounting principles are allowed to operate for tax purposes by grace of statute only; the fact remains that they are given recognition. This contrasts sharply with the situation one now finds in the United States, where Congress has retroactively repealed sections of the new Code which were only intended to allow for the first time deductions which have been permitted for many years past in Canada. The most important of these—a reserve for vacation pay—has I am told been allowed for some time in Canada as an accepted incidence of accrual accounting, but it now appears that American industry will have enjoyed a comparable state of benevolence only for a few months by virtue of statutory provisions which have been retroactively repealed.

Japanese Cabinet proposes new taxation of foreigners

WORD HAS JUST BEEN RECEIVED here that the Japanese legislature has enacted a law, effective April 1, 1956, to prevent a sharp and sudden increase of personal income tax on resident foreigners as a result of the expiration of special measures. The bill can be summarized thus:

1. For the purpose of income tax for the taxable years 1956 to 1960, inclusive, salary falling under a certain category (see Note), of a taxpayer who is resident for one year or more in Japan but who is not domiciled in Japan, shall be taxed on the amount paid in Japan plus the amount remitted to Japan.

2. The minimum amount of salary subject to the income tax of Japan shall be set in the years of 1957 to 1960 inclusive. This minimum amount of such total salary shall be 60% for 1957, 70% for 1958, 80% for 1959 and 90% for 1960, respectively, of the total amount of such salary which includes the part, if any, of salary paid outside of Japan.

Note: These measures will apply to taxpayers whose salary is paid by a corporation or other entity (1) conducting a business designated by the Ministry of Finance as contributing to the sound development of the Japanese economy; (2) engaged in scientific, educational, or other activity for public, nonprofit purposes and designated by the Ministry of Finance as promoting the international exchange of culture. The relief measures will apply also to teachers in schools and colleges, and to the salary of a minister or missionary from a religious organization. ☆

Appraisal of Barlow & Wender report on taxation of U. S. business abroad

THE INCREASING attempts by foreign countries to entice American investment makes particularly timely the publication of *Foreign Investment and Taxation* (New York, Prentice-Hall, 1955, $15). Authors E. R. Barlow and Ira T. Wender, of Harvard's International Program in Taxation, have in this volume combined extensive interviews with corporate executives with an intensive analysis of already-known data, in an effort to find out the factors important to investors in reaching decisions regarding foreign investments (other than in Canada), the way such decisions are made, and the effects of taxation on investment policy. Included also: an original proposal for U.S. income-tax deferred through establishment of a new classification, a "U.S. Foreign Business Corporation."

G. F. Salman, controller of Philipp Brothers, New York, made these brief but pertinent comments on the book recently in *The Controller*. He reports that the study establishes clearly that:

1. Comparatively few corporations account for almost all U. S. investment abroad.

2. Such concentration in few hands is even greater than in U. S. domestic business.

3. No dramatic shift in types of investment has occurred in the last 25 years.

4. Growth of foreign investments has followed, largely, this pattern:

a. What started as export business became foreign investment to protect and retain the foreign market;

b. Investment became necessary for protection of source of supply for domestic market.

5. The relatively low asset value of newly-established foreign investment units is due to

a. U. S. companies' dislike for an initially large capital investment in foreign countries, and

b. Preference for financing expansion through reinvested earnings from foreign operations.

As for expansion, it is important to note the clash of interests between the U. S. and other nations' points of view: "While we feel the need to encourage foreign expansion of mining, petroleum and some agriculture in order to meet expected raw material requirements, the foreign countries' needs are largely in finance, transportation, communication, and public utilities, precisely the fields where U. S. foreign investment has failed to expand, perhaps because of the incompatibility of terms offered by these foreign countries and conditions required by U. S. capital."

Elaborating on the attitudes of companies toward foreign investment, Surrey and Wender's field research utilized the interview technique to obtain as completely as possible answers to these specific questions:

1. Why do companies invest?
2. How do companies invest?
3. Why do companies not invest?

The detailed reaction by corporate executives to these three questions and the careful evalution of the answers—often possible only after insistent prodding and winnowing to ascertain more than generalities and confused recollections—make fascinating reading.

Tax incentive plan

Barlow and Wender agree with the idea that additional foreign investment can be stimulated through a tax-incentive plan, provided it meets with the following requisites:

1. Has sufficient dramatic appeal to attract attention and interest executives in the idea of foreign investment.

2. Accommodates the natural tendency to expand out of foreign earnings by permitting, without paying U. S. tax, accumulation of such earnings for investment in countries other than where earned.

3. Encourages shift from export operation to foreign investment.

4. Offers tax advantage on foreign earnings only if *benefit is tied to future investment.*

After further exhaustive analysis and discussion of the present taxation of corporate foreign income, with regard for its many intricacies, the inequities and difficulties of the source-of-income and title-passage rules are explored and recommendations advanced for their application to the new corporate creation.

The book culminates in a proposal for the establishment of the U. S. Foreign Business Corporation. In the authors' own words:

"The Proposal differs from most recommendations for tax stimuli for foreign investment in that it does not rely on substantial rate reduction; instead [it is] the privilege of deferring U. S. tax [that] provides an incentive for companies to invest abroad . . . We have elaborated in the proposal so as to demonstrate its technical feasibility and to indicate that it can be legislatively executed in a manner which will protect the revenue . . . The important point in our opinion is that if a tax incentive is to be provided for foreign investment, the incentive should be one of deferring U. S. taxes on foreign income used for further foreign investment."

Questions on conclusions

Richard C. Munsche, manager of the tax department at Coca-Cola Export Corporation, gives us a strong critical evaluation of some of the Barlow and Wender conclusions. Writing in 69 *Harv. L.R.* 972 he made the following points (among others):

There appear, Mr. Munsche writes, to be a number of important questions which may be asked concerning the principal thesis and recommendations of the book. Have the authors convincingly demonstrated that the elimination or substantial reduction in the rate of United States income tax would be only a minor incentive for foreign investment? Would tax deferment be a more effective incentive? If so, does the specific proposal for a United States Foreign Business Corporation represent a practical and desirable means of accomplishing this purpose? Should so-called "export" income, that is, income from the sale of goods made in the United States which are shipped directly to a foreign customer, be treated as income from foreign sources for the purpose of the gross income qualifying test of a United States Foreign Business Corporation?

The contention of the authors that the United States income-tax rate plays a rather minor role in the decisions of management regarding foreign investments is in apparent conflict with the overwhelming preponderance of replies by businessmen to a Department of Commerce questionnaire to the effect that the major incentives which the United States Government could furnish to prospective foreign investors would be tax advantages (pp. 110-12). The majority of replies favored the complete elimination or a substantial reduction in rate of United States income tax on in-

come derived from the active conduct of a trade or business abroad. The authors seem to attribute these recommendations to the general desire of businessmen for tax reductions wherever there is a plausible argument for such reductions, and contend that there is no evidence to indicate that such an elimination or a reduction in rate of United States tax on foreign income would result in the most effective inducement to investment in foreign countries (pp. 137, 281-97).

Criticism of interview technique

The story of the interviews of the authors with company executives favoring exemption from United States tax is perhaps the least convincing portion of the entire book (pp. 282-87). It would appear that almost every interview opened with the company executives expressing strong opinions in favor of elimination of United States tax on foreign income, that it then developed as the result of close questioning and discussion that the changes in the United States tax laws they advocated would not have affected actual investment decisions by their company, and that by the end of the interview the company executives had either reversed their viewpoint or their arguments had proved to be inadequate to justify their views. On the other hand, it does not appear that any effort was made to point out to executives not favoring exemption from United States tax that there might be some merit to that idea.

The fact remains that the tax aspects of any prospective investment or transaction, domestic or foreign, are receiving more and more attention from executives. The interest which has been expressed by business executives in recent bills proposing tax relief in respect of foreign income is an indication that the impact of United States income taxes on foreign income is a matter of more than nominal interest to the business executive. It is true that the general corporation executive comes to accept the prevailing rate of tax on domestic income as a normal tax burden. If the current rate of tax on domestic income is 52 per cent, he does not ordinarily express any particular concern whether the United States income tax on income from a foreign country is 32 per cent (where the foreign tax rate is 20 per cent), or whether the net United States rate is 12 per cent (where the foreign tax rate is 40 per cent). It would seem to follow that, if management accepts the prevailing United States rate as a norm, a substantial reduction in rate below that level would constitute a direct and powerful incentive to investment abroad.

It may be granted that it is difficult to isolate and identify specific examples of the effect of the United States income tax on foreign investment, but the lack of such proof does not by any means indicate the absence of such an effect. The authors agree that the interest and enthusiasm of top management for foreign investment is a matter of primary importance and emphasize the need for a dramatic appeal in any tax-incentive plan. The burden of taxation is being brought daily to the attention of the corporate executive, and it is reasonable to believe that the elimination or substantial reduction of tax on foreign income would contribute importantly to his enthusiasm for investment abroad. In the opinion of the reviewer, the authors have not made a convincing case for the proposition that the United States income tax is an unimportant element in the foreign investment process and that its elimination or reduction would not be an effective incentive.

Good case for deferment

The authors do, however, make a good case for giving preference to a dramatic plan for deferment of United States income tax on foreign income as an aid to expansion of foreign investment. In the case of earnings which are permanently invested abroad, the deferment of such tax is equivalent to complete elimination of the United States tax. If the foreign rate is low, such earnings will be taxed in only a nominal amount and the tax incentive is clearly a powerful one. The rate of return on reinvested profits could be doubled in some cases. Only the profits emanating from such investment which are ultimately transferred to the United States stockholder would be subject to United States income tax. As the amount of incentive would be inversely proportional to the rate of foreign income tax, there would be a great inducement on the part of United States companies to seek foreign countries having low effective rates of income tax, generally the so-called underdeveloped countries, in which to make foreign investments. It is also true that the tax benefits thus received would be proportional to the foreign investments made, assuming that the deferment provisions are drawn sufficiently tightly so that the income on which the tax is deferred would have to be devoted to the active conduct of a trade or business abroad.

It does not necessarily follow, however, that a rate differential applicable to distributed earnings would not also constitute a powerful incentive to engage in foreign operations. In the case of industries where the possibilities of reinvestment abroad are not at the time of making the investment clearly in prospect, the deferment regime may have relatively little attraction. Members of an industry requiring a comparatively heavy investment in plant and machinery will be favored under a deferment regime, as compared with companies which require a relatively small amount of investment; yet the latter companies may be able to make a very substantial contribution to the economy of foreign countries by introducing American techniques, ideas, and know-how. The deferment regime which has been advocated does, after all, provide benefits only for reinvested profits; but the objective of the prospective foreign investor is primarily the profits which may ultimately be brought back to the United States, and therefore distributed profits as well as undistributed profits should be made eligible for benefits under any well-rounded incentive program.

To sum up, the deferment regime which has been advocated appears to be generally sound, and might logically precede but should not completely preclude the use of a rate differential as an incentive.

The specific proposal for a United States Foreign Business Corporation would, if enacted, constitute a useful management and financial device for the conduct of business outside the United States, a device far superior to the foreign holding companies to which American corporations have been forced to resort because of the tax disadvantages of domestic corporations under our present law. The United States Foreign Business Corporation would be entitled to the benefits arising out of the network of tax treaties between the United States and foreign countries which has been laboriously built up over a period of years. As a management device such a corporation would be most helpful in concentrating all of a company's foreign activities under a domestic "umbrella," as it has been called, without the need

for involvement in the tax laws, politics, and legal system of an intervening third country, such as is required in the case of foreign holding corporations.

British proposals

It is interesting to note that the proposal for a United States Foreign Business Corporation was made at almost the same time that the British Royal Commission on the Taxation of Profits and Income made a very similar proposal for the establishment of "overseas trading corporations" under United Kingdom law which would be exempt from United Kingdom tax until distribution of profits by such companies to their shareholders resident in the United Kingdom. The Commission also considered the elimination of tax on foreign income and rejected it in favor of deferral.

Tax-shelter countries

As far as an incentive to foreign investment is concerned, one possible objection to the United States Foreign Business Corporation proposal is that American companies have already available to them the possibility of forming foreign holding or holding-and-operating companies in any one of a number of tax havens such as Panama, Canada, the Bahamas, and other countries exempting income earned outside their borders or imposing no income tax at all. It has been pointed out, however, that the use of these companies is for all practical purposes restricted to new investors, because the transfer of existing foreign operations to a foreign subsidiary may be effectively barred by the Treasury under existing law, and, even to new investors, there are certain undesirable aspects of forming foreign holding companies, as mentioned before.

The authors' underlying idea seems sound and, if accepted, should result in a decided improvement in the United States taxation of foreign business income.

The statistics, observations, and recommendations contained in this book make it required reading for anyone seriously interested in the United States taxation of foreign income. ☆

New decisions

Swiss here as employee exempt; independent contractor not. A resident of Switzerland who is engaged in the U. S. in demostrating and selling logging equipment, together with the logs produced during such demonstration, is engaged in a trade or business here, and the income therefrom is subject to tax. However, a Swiss resident brought into this country by this Swiss employer to aid in the demonstrations qualifies for tax exemption of income from personal services if he remains in the U. S. not more than 183 days during the year. *Rev. Rul.* 56-165.

Dutch resident who taught here previously may enter upon another exemption period. The U. S.—Netherlands tax treaty provides that a professor in the U. S. for a maximum period of two years is exempt from U. S. tax on his salary. A resident of The Netherlands whose income derived from teaching in the U. S. was so exempted and who has left the U. S. may, upon his return, enter upon another exemption of two years provided he has been absent from the U. S. for a period of at least one year and he still meets the requirements of Article XVII. The rule about the year between visits is based on a technical memo by the State Department to Congress. *Rev. Rul.* 56-164.

No exemption for pension received from foreign government. A pension received from a foreign government by a resident of the U. S., a former representative of the foreign government, is not exempt. Certain wages received by an employee of a foreign government are. *Rev. Rul.* 56-44.

Cuban excess-profits tax an "income tax." The tax imposed by Article 15 of Cuban Law No. 7 of 1943 on excess profits is an income tax for purposes of the foreign tax credit. *Rev. Rul.* 56-51.

Foreign tax credit for Cuban production tax. Taxpayer, a U. S. corporation, manufactured and sold Coca-Cola in Cuba. On its U. S. tax returns for 1944 and 1945 it claimed as foreign tax credits income tax and Cuban taxes on capital and production. The Commissioner denied credit for the production tax, claiming that it was not a tax paid in lieu of a foreign income tax. Analyzing the Cuban law, the court finds it is in lieu of an income tax. *Compania Embotelledora Coca-Cola,* S.A. Ct. Cls., 4/3/56.

Foreign corporations can't be "collapsible." A foreign corporation deriving all of its income from sources outside the U. S. has no "taxable income" and cannot be considered a "collapsible corporation" upon liquidation or sale of its stock by a U. S. citizen. *Rev. Rul.* 56-104.

Foreign tax credit computed on market value of dividend in kind from subsidiary. [*Non-acquiescence*] Taxpayer received dividends from a Puerto Rican subsidiary of cash of about $270,000 and property with a value of about $1,440,000, totalling $1,710,000. However, the property had cost the subsidiary only some $360,000, making the dividend at subsidary's cost only $630,000. The accumulated earnings and profits of the subsidiary exceeded $1,710,000. Therefore the entire distribution was a taxable dividend, against which there is a credit for foreign taxes paid by the practically 100%-owned subsidiary. The credit is the same proportion of taxes paid as the dividend is of accumulated earnings. In this computation taxpayer would multiply taxes paid by the fraction $1,710,000/surplus. The Commissioner would use the fraction $630,000/surplus. The court held for the taxpayer. "Dividend" must have the same meaning everywhere in the Code, *i.e.,* fair market value. *Central Aguirre Sugar Co.,* 24 TC No. 70, *non-acq.* IRB 1956-15.

Word "day" in U.S.-U.K. tax treaty defined. "Day" when used in the treaty with respect to the exempt status of compensation for personal services performed for 183 "days" or less by a U.K. resident in the U.S. is interpreted to mean a day during any portion of which taxpayer was physically present in the U.S. *Rev. Rul.* 56-24.

18-month contract makes carpenter resident of Arabia. Taxpayer contracted in July, 1948, to work as a carpenter in Saudi Arabia for 18 months. He remained there for the entire year of 1949 and until May of 1950. He then returned to the United States. The court holds that he is not taxable on his Arabian earnings as a "bona fide resident" there. Residence in a foreign country is to be distinguished from presence as a transient or sojourner. The taxpayer was a resident of Saudi Arabia in 1949, because he had contracted to work there for a period extending beyond the end of the taxable year. *Ditman,* DC Md., 12/23/55.

CORPORATE & PERSONAL PROBLEMS IN

Taxation of compensation

EDITED BY JOHN P. ALLISON, LL.B.

Stock option given employee is compensation; Supreme Court reverses LoBue case

As we go to press the United States Supreme Court announced its decision in the *LoBue* case. The Third Circuit had upheld the Tax Court view that whether or not a stock option given LoBue, an employee, was compensation was a question of fact. The courts below found that in LoBue's case the option had been given him to create for him a proprietary interest in the business, and not as compensation. In holding such payments to be compensation the Supreme Court in effect gives new validity to the Commissioner's old regulation which was based on *Commissioner v. Smith*, 324 U.S. 177.

Mr. LoBue was employed as an executive by the Michigan Chemical Corporation. His option was given him by the company with the statement that it was intended to induce him to devote his wholehearted efforts to the company. The option price was $5 per share, slightly higher than the then market price of the stock.

Four judges on the Tax Court dissented in the original decision. ☆

New decisions

Legal actions cannot be lumped together to make fees long-term. Taxpayer, an attorney, was retained by several clients in a common action. The court, however, requires him to treat such claim separately in determining whether the fee can be taxed as if received over the period earned. [1954 Code Section 1301(b) adds a definition of employment as "an arrangement or series of arrangements . . . to effect a particular result, regardless of the number of sources from which compensation therefor is obtained." *Ed.*] *Drysdale*, CA-6, 4/9/56.

Salary payments of $9,000 to each of two officers held reasonable. Payments of $9,000 by a corporation engaged in the business of buying, repairing, leasing, and selling real estate to each of its two principal officers was held to constitute compensation for services rendered in the taxable year and in prior years and was deductible by the corporation as reasonable salaries paid. The officers devoted several days a month to taxpayer's affairs. From 1942 to 1950, the years in question, they had received salary in only one year. The Commissioner had disallowed the entire amount claimed on the ground it was really a dividend—the payments were proportional to stockholdings and no withholding was made. But despite this ambiguous record the court held for taxpayer. *K & H Realty Corp.*, TCM 1956-107.

Lump-sum payment on termination of pension plan taxable as capital gain. Taxpayer was employed by a corporation which liquidated and transferred all its assets to its sole stockholder, who continued to carry on the business. Taxpayer continued as his employee. Upon liquidation, the corporation's tax-exempt pension plan was terminated, and taxpayer received a lump-sum payment for his rights in the fund. The court holds the payment was received on account of separation from the service of the employer and was taxable as a long-term capital gain. The court followed *Miller* (*aff'd.* 226 F.2d 618) in holding that "separation from service" means service of the particular employer, not the business enterprise as an economic entity. *Martin*, 26 TC No. 9.

Sickness benefits under employee plan are exempt. The court held that amounts received as sickness disability benefits under the self-insured Employees' Sickness Benefit Plan of Western Electric Co., Inc., were exempt as health insurance under 1939 Code Section 22(b)(5), citing, among other cases, *Epmeier*, CA-7, and a district court decision in *Haynes* (since reversed on appeal). [1954 Code Section 105 now excludes $100 a week sick pay without regard to whether the plan is "insurance." *Ed.*] *Priebe*, DC Ariz., 4/9/56.

For Section 107, lawyer can separate fee of executor and estate. [*Acquiescence*] Chase, an executor of an estate, engaged Irving, an attorney, to litigate for possession of certain property. For such extraordinary services Irving received $40,000 and shortly thereafter became attorney for the estate. The $40,000 payment was less than 80% of the total compensation received from the estate. Irving did qualify under Section 107 with reference to the $40,000 fee. His services as attorney for Chase were independent and divisible from his later services rendered as attorney for the estate. *Irving*, 25 TC No. 50, *acq.* IRB 1956-18.

Attorney's services in reorganization and as counsel separate for Section 107. [*Acquiescence*] Taxpayer was attorney for a railroad in reorganization and also its general counsel. The ICC awarded him $20,000 in 1945 and $5,000 in 1946 for services on the 1944 plan of reorganization. In 1946 he also received a separate award of $3,800 for services as general counsel. The 1944 plan was later abandoned, and taxpayer worked on a 1949 plan for which he received $35,000 in 1951. For purposes of applying the long term compensation relief provisions of Section 107(a) each service was held separate and distinct having been so regarded by the ICC. For the 1944 plan, which was separate and distinct from the 1949 plan, he was to receive a total of $25,000, and since more than 80% or $20,000 was received in 1945, he was entitled to application of Section 107(a) in that year. *Pierce Estate*, 24 TC 95, *acq.* IRB 1956-18.

Commissioner yields; may split Section 107(a) income for services prior to 1/1/48. The IRS has revoked *Rev. Rul.* 54-206 and now concedes that for purposes of Section 107(a) of the 1939 Code a husband and wife who reside in a non-community property state may split income received by the husband on or after 1/1/48 and before 3/1/54 for personal services rendered by him during taxable years beginning prior to 1/1/48 and taxed as though received when earned. *Rev. Rul.* 56-210.

NEW DEVELOPMENTS IN

Taxation of oil & gas

EDITED BY GODFREY WM. WELSCH, LL.B., CPA

Deductibility of expenses in excess of income in A-B-C transactions to be tested

THE "A-B-C DEAL" is by far the most popular method of acquiring producing oil properties because it enables the purchaser to pay a substantial part of the consideration for the properties with funds upon which he never has to pay an income tax. The factors giving rise to this favorable treatment are as follows:

1. When oil leases are transferred in consideration of a cash payment and an oil payment to be satisfied from the property conveyed, the transaction is in part a sale for cash and in par a reservation of an economic interest in oil in place; that is, the vendor is considered as never having sold that portion of the oil in place necessary to satisfy the oil payment *(Commissioner v. William Fleming,* et al, 82 F. 2d 328 (CA-5); *H. R. Cullen v. Commissioner,* 118 F.2d 651 (CA-5); *GCM 22730,* 1941-1 CB 214).

2. In a transfer of producing properties for cash plus a reserved oil payment, the cash received is first applied as payment for the depreciable equipment to the extent of the basis thereof. The basis in the depletable property is allocated between the interest sold and the interest retained in proportion to the fair market value of each. The gain on the transaction is the excess of the cash received over the sum of the bases in the depreciable property and the depletable interest sold *(Columbia Oil & Gas Company v. Commissioner,* 118 F(2d) 459 (CA-5); *GCM 23623,* 1943 CB 313).

3. The reservation of an oil payment does not prevent the treatment of gain, realized on the cash sale of the equity interest, as capital gain *(H. R. Cullen v. Commissioner,* 118 F(2d) 651 (CA-5)).

4. The sale of an in-oil payment right which constitutes the entire depletable interest of the vendor in the property results in capital gain *(GCM 24849,* 1946-1 CB 66; IT 4003, 1950-1 CB 10).

In the operation of the property the working interest owner must bear the cost of lifting all the oil, namely, the royalty oil, the oil-payment oil, and the working-interest oil.

It is accepted law that the operator does not have to capitalize the cost of lifting royalty oil. However, it has been the contention of the Treasury Department that when the cost of lifting the oil necessary to satisfy the oil payment exceeds the net income from the property, such excess must be capitalized as additional lease cost recoverable through depletion.

If this position of the Treasury Department were sustained by the courts then a loss from such an operation would not be available to reduce other income of the taxpayer but would be considered to be additional cost of the equity interest acquired. This position may soon be tested in a case pending before the U. S. District Court in Tulsa. *(Francis Oil Co.)* The facts in this case are as follows: In 1948 the Francis Oil Co. purchased a one-half interest in 23 producing leases in Kansas for a total consideration of $540,000 payable $165,000 in cash and $375,000 out of 95% of the production from the one-half interest in the leases acquired. The Francis Oil Co. incurred operating expenses in excess of the 5% of the production received by it and in addition it incurred intangible drilling and development costs. The Internal Revenue Service denied these deductions to the extent that they exceeded Francis' share of the gross income, stating that the excess should be capitalized as additional cost of the leases acquired. Francis paid the tax and filed claim for refund. The government has subsequently amended its position several times. It now concedes that Francis was entitled to the deduction for intangible drilling and development expense to the extent of its ownership in the working interest, without regard to the amount of gross income received. The present controversy is therefore concerned solely with the deductibility of operating expenses in excess of the operator's share of the gross income. Taxpayers' brief has been filed by Roger S. Randolph and Robert L. McGowen of the firm of Couner, Winters, Randolph & Ballaine. The government's brief was to have been filed by June 4.

Both from the government's pleadings in this case and from recent letter rulings issued to taxpayers, it now seems settled that it is the present position of the Commissioner of Internal Revenue that intangible drilling and development costs incurred are deductible without regard to the gross income received from the property but that operating costs in excess of gross income represent additional lease cost and must be capitalized if, at the time that the deal is made, it is apparent from all of the factors then known that the purchaser cannot cover his operating expenses from the income he will receive from his interest. We understand that, in evaluating this pay-out period, the transaction is to be viewed as a unit. Thus, where several leases are involved, it is not necessary that the operator receive enough from each lease to cover the expenses of that lease, so long as all the leases acquired in the transaction can be expected to cover the total expenses involved. And, of course, intangible drilling and development expenses are not to be considered in determining whether receipts will cover expenses.

Indications are that the *Francis Oil* case will never go to trial but will be settled out of court. ☆

New decisions

Offshore wells drilled slantwise from land; depletion allowed landowner. The law of the State of California provides that its offshore oil can be extracted only from wells drilled on filled land or slant drilled from upland drill sites to the submerged oil deposits. Taxpayer agreed with upland owners to pay them 24.5% of the net profit for the right to drill from their land. Taxpayer argued that it was entitled to depletion on the proceeds of sale of all the oil produced,

HOW THE A-B-C DEAL WORKS IN ACQUISITION OF OIL PROPERTIES

FOR THOSE UNFAMILIAR with the transaction, the following extract from the *L. R. B. & M. Journal* Tax Supplement of January, 1956, will explain how the A-B-C deal works:

"The basic pattern of the A-B-C transaction is the acquisition of a producing property largely with funds provided by the sale of an oil payment carved out of the property to be acquired. For example, assume the following set of facts: A owns the working interest in an oil and gas lease with estimated reserves of 300,000 barrels of oil. Oil is selling at $2.50 per barrel, lifting costs are 30 cents per barrel and it is expected that the working interest will produce 50,000 barrels of oil in the current year. A is willing to sell his property for $300,000 if the proceeds will be taxed at capital gains rates. C, an operator, has $50,000 in cash but he knows that he can borrow $250,000 from a bank at 4% interest by pledging the oil property as security for the loan and assigning 80% of the oil runs from the property to the bank until such time as the loan is liquidated. C wishes to purchase the property, but he realizes that the oil runs will constitute gross income to him, despite the fact that they are assigned to the bank to pay off the loan, and that therefore he will incur heavy taxes during a period when he will not have the cash to pay them. So C arranges to purchase the property in an A-B-C transaction. B, an investor, is called into the picture. C purchases the property from A for $300,000, payable $50,000 in cash and $250,000 out of 80% of the first oil to be produced from the property. The 'oil payment' of $250,000 is to bear interest at 5% on any unpaid balance. Immediately after, or coincident with, the purchase of the property by C from A, B acquires the 'oil payment' from A for $250,000. B borrows the face amount of the oil payment from the bank at 4% interest, assigning the oil runs to the bank in liquidation of the loan.

"Under current Treasury rulings and decided cases, A realizes capital gain with respect to both his sale of the working interest and his sale of the oil payment. B, the holder of the oil payment, is allowed to take cost depletion as a deduction so that his taxable income is limited to his real profit on the transaction, which is the difference between the interest he is receiving on the oil payment and the interest he is paying the bank on his loan—in this example 1%. Because the oil payment is an economic interest in the oil in place which was never acquired by C, the operator, it is not necessary for C to include in his income the oil which goes to pay off the oil payment.

"The following tabulation compares, for the first year of operation, the results to C of his purchase under the A-B-C method with the results that would have accrued if he had borrowed the $250,000 from the bank and purchased the property for $300,000 cash.

	Cash Purchase	*A-B-C Transaction*
Gross receipts[1]	$125,000	$125,000
Less, 80% to holder of oil payment	—	100,000
Gross income	125,000	25,000
Lifting costs[2]	15,000	15,000
Interest	10,000	—[3]
Net income before depletion	100,000	10,000
Depletion	50,000[4]	5,000[5]
Taxable income	50,000[6]	5,000
Tax at assumed rate of 50%	$ 25,000	$ 2,500

C's net cash position under each of the two methods is as follows:

	Cash Purchase		*A-B-C Transaction*	
Receipts		$125,000		$125,000
Less:				
Oil runs to bank	$100,000		$100,000	
Lifting costs	15,000		15,000	
Taxes	25,000	140,000	2,500	117,500
Net		($ 15,000)		$ 7,500"

[1] 50,000 barrels at $2.50 per barrel.
[2] 50,000 barrels at $.30 per barrel.
[3] No interest deduction is allowed because the interest on an oil payment is considered as merely an addition to the face amount of the oil payment.
[4] Cost depletion at $1.00 per barrel.
[5] Percentage depletion limited to 50% of net income.

without deduction of this 24.5%, because that was not a depletable royalty. The Court holds that the upland owners are entitled to depletion on the payments to them. A taxpayer is entitled to depletion where he has "(1) acquired by investment, any interest in the oil in place, and (2) secured by legal relationship income derived from the extraction of the oil, to which he must look for a return of his capital." In this case, there is no doubt that the second factor is complied with. Furthermore, because of the proximity of the uplands to the offshore oil and the absolute requirement that the wells be drilled from such land, the Court finds that the value of the land was greatly enhanced by the control over the offshore drilling, and the owners had, therefore, an economic interest in the oil in place. It follows that taxpayer must compute its depletion on its sales proceeds as reduced by the royalty to the landowners. *Southwest Exploration Co.*, U.S. Sp. Ct., 2/27/56.

Talc depletion allowed on income from treatment processes. After mining talc, taxpayer processed it into either crayons or powder. It otherwise was not marketable. The Commissioner attempted to differentiate between treatment processes and manufacturing and determined that since processing was a manufacturing process and could not be considered "mining" the gross income from the sale of powder and crayons could not be the basis of the 15% depletion deduction. The district court held that the

act clearly provides that the entire process of obtaining a marketable product falls within the definition of "mining." Therefore, whether the process which is utilized be one of manufacture or treatment is immaterial. The cost of cartons and bags used to pack the product for sale was held to be a necessary expense for marketing the products and their cost need not be deducted from the gross sales to compute gross income subject to depletion. This court affirms. *Hitchcock Corp.*, CA-4, 4/9/56.

Mine expenditures deductible because incurred in production. The 1939 Code provided that the net excess of expenditures over receipts while a mine was in the development stage had to be capitalized. Taxpayers asserted its 1947 and 1948 losses on a particular mine were deductible because the mine was in the production stage in those years. The Tax Court found it was still developing, because all the coal mined came out of entryway and airway tunnels. The mine had been producing in 1946 and the court held that the same status was maintained during the years involved, in each of which more coal was mined than in 1946. Production from entryways and airways was no more expensive than regular "room" mining, and had the effect of maintaining production in a fully-developed property. [For 1951 and later years, the deduction of certain mine development expenditures is allowed by the Code. *Ed.*] *Clear Fork Coal Co.*, CA-6, 2/6/56.

EXEMPT INSTITUTIONS: RECENT DECISIONS

Hospital exemption tests outlined. The IRS has outlined the following criteria or tests to be met in determining whether a hospital can qualify for tax exemption: (1) it must be organized on a nonprofit basis for the care of the sick; (2) it must operate to some extent for those unable to pay; (3) it must not restrict the use of its facilities to a particular group of doctors such as a medical partnership association; (4) its net earnings must not inure directly or indirectly to the benefit of any shareholder or individual. *Rev. Rul.* 56-185.

Exempt organizations must file Forms 1096 and 1099. An organization exempt from tax must nevertheless annual information returns on Forms 1096 and 1099 reporting payments of income made during the calendar year (except payments reported on Form W-2). *Rev. Rul.* 56-176.

Public power unit taxable; its income did not "accrue" to state in year no dividend was paid. The Omaha Public Power District owned all the stock in Western Iowa Power Co., which derived all its income from a public utility. Iowa sought to come under Section 116(d) of the 1939 Code, which exempted from tax income derived from any public utility and accruing to any political subdivision. The court holds that Iowa's income did not "accrue" to the Omaha, a political subdivision, because no dividends were declared. Actually, Omaha received taxpayer's income by sale of the taxpayer's stock but this, the court holds, does not qualify for the exemption. *Omaha Public Power District*, CA-8, 5/3/56.

Railroad controlled by RFC is not tax-exempt. A reorganized railroad company which has issued all of its first mortgage bonds and the majority of its shares of common stock to the Reconstruction Finance Corporation in satisfaction of a debt, and has also issued and set aside shares of its common stock for subscription through warrants issued to private creditors, is not exempt as a public corporation. *Rev. Rul.* 56-93.

Organization servicing members not exempt as a business league. An organization operated primarily for the purpose of promoting, selling and handling the national advertising in its members' publications performs particular services for the individual members as distinguished from activities for the improvement of the business conditions of its membership as a whole. Accordingly it is not entitled to tax exemption as a business league. *Rev. Rul.* 56-84.

Commissioner can rescind tax exemption retroactively. In 1934 and again in 1938, the Commissioner held taxpayer to be exempt from taxation as a club organized and operated exclusively for pleasure, recreation, and other nonprofit purposes. On July 16, 1945, the Commissioner informed the club that he had been mistaken in his prior rulings in which he granted the exemption, because the term "club" for the purposes of the exemption statute was meant to be an organization in which there was a "co-mingling of members, one with the other, in fellowship." Since the taxpayer was not a club in that sense, it did not qualify for tax exemption. The Commissioner ruled that the automobile club would have to file tax returns for 1943 and 1944. The club admitted taxability for the period subsequent to July 16, 1945, but contended that the Commissioner acted arbitrarily and without authority in requiring returns for 1943 and 1944. The court disagrees. From 1934 on, the Commissioner had acted under a mistake of law, which he could correct at any time. In other cases where the Commissioner has been held to prior rulings, no such mistake of law was involved. Furthermore Section 3791(b) of the 1939 Code specifically granted the Commissioner the right to determine the extent of the retroactivity of any ruling. He waived returns for 1934 to 1942, and did no undue harm to the taxpayer by requiring returns from 1943 on. The court also holds that the Form 990 filed by the Club while it thought itself exempt was not a tax return which commenced the running of the statute of limitations. One judge dissents: a construction of the law, if not plainly erroneous, must be treated as read into the statute. There was valid ground for the previous position. Consequently it cannot be rescinded retroactively. *Automobile Club of Michigan*, CA-6, 2/17/56.

Student government association need not file return. A student government association which is an integral part of and controlled by a university exempt from federal income taxes as an educational organization is not required to file annual return Form 990-A. It is part of the university, which is itself exempt from filing this form. *Rev. Rul.* 56-133.

No exemption for organization formed to benefit individual members. A local organization whose principal activity consists of furnishing information to and advertising the products of its members engaged in a particular industry through publications and other means does not

qualify for exemption as a business league. Exemption applies only to organizations operated primarily to promote the interests of particular industries as distinguished from operations primarily as a service to its individual members. *Rev. Rul.* 56-65.

Employees' trust not exempt as a charity. A trust organized and operated for the primary purpose of paying pensions to retired employees and to provide in addition incidental benefits to employees or their beneficiaries in times of need is not exempt as a charitable organization. *Rev. Rul.* 56-138.

Statements to be furnished by state credit unions. The Service will accept a form of statement furnished by the Credit Union National Association in lieu of articles of incorporation, by-laws, and financial statements as evidence of the exemption requirements which state-chartered credit unions must fulfill. *Rev. Proc.* 56-2.

Membership committee of farmers' cooperative may hold stock as trustee for members. A farmers' cooperative, otherwise exempt, will not be denied exemption if a substantial part of its voting stock is held by the membership committee in trust for the members. Stock so held qualifies as owned by producers. *Rev. Rul.* 56-21.

Taxpayer, owned by club members, not exempt; taxed on sales of land. The members of a hunt club organized taxpayer corporation, which acquired land used for hunting. The club members had to own stock in the taxpayer; the corporation had an option to repurchase shares at book value if they were transferred to a person not approved by the Board of Directors. In 1946 and 1948, the taxpayer sold timber from its land. The Commissioner argued that the timber sales resulted in taxable income, and the court agrees. The exemption provisions of the statute must be strictly construed. Even though its stockholders were members of the club, the taxpayer itself was not a club and had no members. Furthermore, under certain circumstances, it could buy back its stock at book value, in which event part of its net income would "inure to the benefit" of the selling stockholders. *Kanawha-Roane Lands, Inc.*, DC W.Va.

Corporation owning community recreation building exempt. Taxpayer acquired a building which was, according to its charter, to be maintained as a community building for the use of Slovene organizations. Memberships in the corporation were owned by various clubs and lodges. The corporate income was derived from renting the bottom floor as a tavern, and from parties run during the year by its members. The court holds that the corporation was organized and operated exclusively for recreational purposes with no part of its net income to inure to the benefit of a private shareholder. It was, therefore, exempt from federal income taxes. *Slovene Workers' Home*, DC Ill., 1/12/56.

No exemption for foundation operating commercial enterprise to benefit family. In 1945 taxpayer was held exempt under Section 101(6) as a charitable organization. Subsequently it acquired a commercial business for the purpose of benefitting private business enterprises owned or controlled by the Lesavoy family. That purpose being the dominant factor in the foundation's operation, the court holds that it lost its exempt status and was taxable as a trust. Penalties for delinquency and negligence were upheld. *Lesavoy Foundation*, 25 TC No. 106.

Employees' association not exempt savings bank; it speculated. Taxpayer was created for the exclusive benefit of employees of a bank. No compensation was paid to the management; it made small loans to employees of the trust company, as well as other investments. In 1943, taxpayer bought some land, subdivided, and sold it. In 1949, 1950, and 1951, other real property was acquired and improved. The taxpayer contended that, in the latter years, it was an exempt mutual savings bank. The court holds that the speculative nature of these transactions branded the association as profit-making and not strictly a savings bank. Therefore it is not exempt. *Guaranty Employees' Association*, DC Tex., 12/29/55.

Jockey Club not exempt; carried on substantial business. Taxpayer was organized by breeders and racers of horses to control the industry. It maintains the records for and publishes a stud book, publishes a monthly racing calendar, licenses and disciplines owners, jockeys, etc. It collects fees for these services and for conducting races. Its net income in 1948 was $60,000 and its surplus over $700,000. The court finds that Congress did not intend to treat such an organization in the same way as a chamber of commerce or a board of trade, which are exempt. Taxpayer was performing services which well might have been done by others for profit. *Jockey Club*, Ct. Cls., 1/31/56.

Members' $50 death benefit makes club taxable. Taxpayer was a club for union members in Erie. It operated a clubhouse with restaurant, etc. The Tax Court held that it did not qualify as a social club because its constitution provided for a death benefit of from $30 to $50. This death benefit was not for social or recreational purposes. The club therefore was not exempt. This court affirms. *Allied Trades Club, Inc.*, CA-3, 1/3/56.

Jury denial of exemption for foundation upheld. The jury found that taxpayer was not exempt as "organized and operated for scientific, charitable or educational purposes." This court affirms. (No facts reported.) *Institute for Trend Research*, CA-1, 3/16/56.

MISCELLANEOUS NEW DECISIONS

Insurance company can pay to beneficiary despite lien against him. In the absence of actual notice, negligence, or fraud, an insurance company will not incur any liability to the government for making payment to a beneficiary against whom a federal tax lien is outstanding. *Rev. Rul.* 56-48.

Life-insurance company in liquidation taxed as ordinary corporation. A life-insurance company which transfers all of its business and assets to another company under a reinsurance agreement, but which continues its corporate existence for the purpose of liquidating and winding up its affairs, ceases to be taxable as a life-insurance company after the effective date of the reinsurance agreement. *Rev. Rul.* 56-106.

Tax lien preferred over subsequent mortgage advances. An advance of money by a mortgage under an "open-end mortgage" subsequent to the original loan does not have priority over an intervening recorded federal tax lien. *Rev. Rul.* 56-41.

NEW DEVELOPMENTS IN

State & local taxation

EDITED BY JOSEPH S. MARTEL

Does Georgia retreat on interstate commerce question? Stockham case dismissed

WE HAVE just received word that the Georgia Department of Revenue has requested the dismissal of the suit filed by Stockham Valves & Fittings, Inc., of Birmingham, Ala., and is refunding to the company the taxes in question. This retreat by the Georgia tax collector involves important interstate questions.

Readers will remember the article on income taxation of interstate commerce (3 JTAX 232) written by Fred L. Cox, Director of Foreign Corporation Income Taxes for the State of Georgia. In this article, Mr. Cox referred to the case then pending in the Superior Court of Fulton County, filed by Stockham to compel the State of Georgia to refund income taxes claimed to have been assessed on income derived solely from transactions in interstate commerce. Mr. Cox stated in part:

"In a bulletin circulated in June 1954 by the instigators of the *Stockham* suit, soliciting contributions to a slush fund sufficient to defray expenses of the suit through the court of last resort, it was strongly implied that Georgia was selected for the legal test because of its more favorable judicial atmosphere. Regardless of the opinion of the National Industrial Council that Georgia is 'best suited to the legal test,' it is appropriate at this time to reaffirm the belief of the Department of Revenue that the Georgia law is valid and to assign some reasons for that belief.

The question in Stockham

"The primary and supreme question presented in the *Stockham* suit is whether the states have delegated to Congress the sole power to impose a tax directly upon net income derived from exclusively interstate commerce. Without such delegation by the states the power is still resident in the states for the power to tax is inherent in the states. The Federal Government is one of only delegated and enumerated powers and the powers not enumerated are not delegated."

In spite of these statements, the *Stockham* cases have been dismissed and the taxes refunded at the request of the Georgia Department of Revenue. However, we are informed that the revenue officials in Georgia do not regard this as a precedent-setting procedure in any sense and that they will continue to press for collection of similar taxes from foreign corporations whose business in Georgia is derived solely from interstate transactions. Presumably, therefore, companies in the same situation as Stockham would have to file for refund and go through somewhat similar procedure as Stockham did.

Nevertheless, it cannot be denied that the retreat in this case must have great significance. Because of its importance, we believe it appropriate to set out for the benefit of our readers the basic facts in the *Stockham* cases.

Facts in Stockham case

The operations of Stockham Valves & Fittings, Inc., represent the types of cases wherein the out-of-state company in 1949 had only a salesman operating in the state and in 1950 maintained only a sales promotion office within the State of Georgia out of which a resident representative operated. A brief resume of the method of operation of the Stockham Company, as set out in its petitions to the court, shows that its principal office and manufacturing plant is in Birmingham, Alabama, and that it had no plant, warehouse, storage room, or stock of goods within the State of Georgia. The company, however, during 1950 did maintain an office in Georgia for the convenience and to serve as the headquarters of a representative whose territory and duties covered several Southeastern states. The principal duties and activities of the representative were "to keep in touch with contractors and users of pipe fittings and valves and to furnish technical information about petitioner's products, and to encourage the specifying of its products in orders to wholesalers and jobbers." Thus, his job was to maintain good will among customers and members of the contracting and building trades who used Stockham products. In no case, however, did this representative or his clerical assistant have authority to or in fact confirm or accept orders, arrange credit terms, make collections, or final arrangements with customers in the State of Georgia. All orders of goods from Georgia customers were subject to approval and acceptance at the Alabama offices of Stockham, and the goods were shipped in interstate commerce to the purchasers in Georgia by common carrier f.o.b. the factory or warehouse in Alabama.

Accordingly, the Stockham Company contended that it did not carry on in Georgia any activities or operations rendering it liable to pay Georgia income taxes, and that it did not receive any net income from property owned or business done in that state, and that the taxes assessed were illegally collected and should be refunded, with interest. In this connection the period of limitations in the Georgia statute requires that to obtain refund of taxes illegally or erroneously collected the taxpayer must file claim for refund within three years after payment of the tax, and actions for refund must be filed within two years from the time the claim for refund is denied.

The petitions of the Stockham Company therefore maintained that the collection of taxes from it was illegal under Section 92-3113 of the Georgia Code (being a part of the Georgia Corporation Income Tax Act of 1933, as amended in 1950) on two grounds. That section, it will be recalled, provides that any foreign corporation shall be deemed to be doing business within the state if it engages in any activity or transaction for financial profit or gain within the state, regardless of whether or not it maintains an office or place of business in Georgia or that any of its activities or transactions are connected with interstate or foreign commerce.

This wide-sweeping declaration of

"doing business" in Georgia with probable tax liability was attacked in the petitions as illegal and invalid on the grounds that:

(a) the statute is in violation of the Fourteenth Amendment to the U. S. Constitution, in that it authorizes the state to tax a foreign corporation which is not actually present or doing business in the state, on taxable events not occurring in Georgia, and to measure the tax by sales or transactions conducted entirely without the limits of Georgia constitutes a denial of due process of law, and

(b) since the Act authorizes Georgia to levy a tax on income derived from sales consummated entirely in interstate commerce, it constitutes a direct interference with and a burden on interstate commerce in violation of the Commerce Clause.

In addition, the petitions of the Stockham Company asserted that the collection of such taxes under that Act was equally unconstitutional under the Fourteenth Amendment and the Commerce Clause for the same reasons. Therefore, refund for $1,736.23 as the amount of income taxes, penalty, and interest illegally collected for 1950 was sought, together with the sum of $282.55 for the taxable year 1949. In the latter situation, refund was sought for the year 1949, becaues the applicable statutory provision (Section 92-3113), although not enacted until 1950, has been given retroactive effect by the State Revenue Commission of the State of Georgia.

[*Since the above article was written we have received word that the Department of Revenue processed refunds in this case because the case had been set down for trial at a time when counsel for the Department was involved in other litigation.*

The Department holds that their withdrawal from this case does not set any precedent for any other taxpayer or even for the same taxpayer in so far as any other years are concerned.] ☆

New decisions

Must show failure to file return was wilful (N.Y.) The court of special sessions in New York City recently held that wilfulness must be proved in any criminal prosecution for failure to file a state income-tax return. A three-judge court handed down a unanimous decision on this point. The prosecution had proved that the defendant's income was well in excess of the amount of $5,000, an amount which makes it mandatory to file a state tax return even if no tax is due. The court unanimously held that in addition to showing this, the prosecution must also prove that the failure to file was done with an intent to evade the law. *Gannon,* 2/8/56.

Georgia "distributor" and "retailer" distinguished. In Georgia, a distributor of motor fuel is entitled to an allowance of 1% of the amount of tax paid. Retailers, on the other hand, may claim a refund of 2% of the amount of tax on fuel sold through them. Where a licensed and bonded distributor owns and operates retail outlets it has been held that the distributor is entitled only to the 1% allowance and he is not permitted to claim the 2% refund on retail operations. A similar ruling has been made with respect to distributor-owned retail stations even though the distributor sells fuel to a non-related subdistributor who in turn is the source of supply for the retail stations owned by the distributor described above.

Pa. court holds promotion not sufficient base for tax. The Court of Common Pleas for Dauphin County on December 27 reiterated its decision in *Commonwealth of Pennsylvania v. Eastman Kodak Company* in which it had held that imposition of Pennsylvania's 1951 corporation income tax on an out-of-state manufacturer which engaged only in promotional activities in the state violated the federal commerce clause. The court had ruled that the tax, although termed a property tax, was on the privilege of doing business. It held that the promotional activities were an integral part of interstate commerce and disallowed the use of an allocation formula—wages, gross receipts, and property—as the basis for computing the tax.

The state complained particularly

J. P. STAPCHINSKAS BECOMES EDITOR

JOSEPH P. STAPCHINSKAS will become editor of this department dealing with state and local taxation in THE JOURNAL OF TAXATION, commencing with the next issue. He succeeds Joseph S. Martel, vice president of McKesson & Robbins, who died late in April.

Mr. Stapchinskas is Manager of the State and Local Tax Department of Ford Motor Company, Dearborn, a position in which he has worked intimately with the taxes of virtually every American jurisdiction. He has long been known as one of the country's keenest students and practitioners of this complicated subject. While Director of Corporation Taxes for the Commonwealth of Pennsylvania, Mr. Stapchinskas was very active in the National Association of Tax Administrators, and he remains a strong supporter of the organization. The Tax Executives Institute recognized his stature in the state and local tax field by naming him Chairman of its State Tax Committee in 1952-1953. He has long been prominent in National Tax Association activities. Mr. Stapchinskas is constantly in demand as a speaker on a wide range of tax subjects, and in the past year has addressed tax and other professional groups throughout the country. He is a recognized authority on the Michigan Business Activities Tax, which presents a new and challenging concept of taxation.

Mr. Stapchinskas will welcome communications from readers, including but not limited to papers for publication (both long and short), queries, ideas that need discussing in print, reports on interesting cases and decisions, and problems being encountered currently. His address is: Office of Tax Affairs, Ford Motor Company, 3000 Schaefer Road, Dearborn, Michigan.

We welcome Mr. Stapchinskas to The Journal of Taxation. We commend his efforts to readers.

The Editors

that the court was in error in failing to consider in the property fraction the company-owned automobiles which were operated by resident salesmen and technical representatives in the state. The court, however, took the view that since it had construed the tax as a privilege tax, the property fraction which was designed to measure the extent of Pennsylvania business activity was no more valid than any other factor of the formula.

Arkansas 300-foot tax "free zone." When Missouri imposed no cigarette tax, sales of cigarettes in Arkansas within 300 feet of the Missouri line were tax-free, the state supreme court ruled in *Culp v. Commissioner of Revenues, Scurlock,* decided December 19. A provision in Arkansas' cigarette-tax law specifies that, although a 6-cents-per-pack tax prevails in the state, cigarettes sold within 300 feet of a state line or in any city which adjoins a state line shall be taxed at the rate imposed on cigarettes in the adjoining state up to the Arkansas rate. Until January 1, 1956, cigarettes were not subject to a state tax in Missouri.

The Arkansas tax commissioner had argued that the above provision applied only where the adjoining state had a lower tax rate but not where it imposed no tax whatsoever. The court read the statute otherwise. He also charged that if retail outlets in Arkansas were permitted to sell unstamped cigarettes it would be next to impossible to enforce the law against importation of untaxed cigarettes, since the legal unstamped cigarettes and the contraband ones would be indistinguishable. The court held there was ample legal authority for the Commissioner to prescribe an identifying stamp for cigarettes lawfully exempt from the tax.

U. S. not purchaser of GI clothing for "resale." An Illinois manufacturer's sale of combat boots to the federal government for subsequent transfer to army personnel did not constitute a sale for resale and was therefore subject to the state's retailers' occupation (sales) tax, the Illinois Supreme Court ruled in *Bellesville Shoe Manufacturing Co. v. Department of Revenue,* decided January 19. At the time of the sale, there were several different procedures by which army personnel acquired boots: through initial issue at the time of entry into the army, through purchase from subsequent clothing allowances, and on a straight issue basis. To an indeterminate extent, officers obtained boots on a resale basis from quartermaster stores.

The manufacturer contended that whether for initial issue or replacement, the boots were transferred for a "valuable, direct, and specific consideration," either cash or services, and that therefore a resale had taken place. The court found no merit in this contention. It pointed out that both federal statute and executive order provided that either clothing be furnished enlisted men or that cash allowances be paid them where it is not furnished. It held that whether an enlisted man was given clothing in kind or paid a monetary allowance, the government was not a purchaser for subsequent resale.

So far as the boots obtained by officers from quartermasters' stores were concerned, the court did not decide whether a resale was involved. It ruled, however, that in any case it was incumbent upon the vendor claiming a partial exemption on a transaction to establish by satisfactory proof the proportion of the sale claimed to be exempt. Since this burden had not been met in this case, the court ruled that no exemption could be claimed.

Tax lien superior to prior perfected mechanic's lien. The U. S. Supreme Court granted certiorari in *U. S. v. Bear Brewing Co., Inc.,* and on the same day, April 10, reversed the judgment of the Seventh Circuit Court of Appeals in a per curiam ruling. The case involved the validity of tax liens filed by the federal government against property of a taxpayer in Illinois. The government's liens were held superior to a mechanic's lien where the private lienor had served process in a foreclosure suit prior to the time the District Director of Internal Revenue received the federal assessment list.

Justice Douglas, with Justice Harlan concurring, dissented on the ground that it was established that the statutory mechanic's lien was specific, prior in time, and perfected in the sense that everything under state law had been done to enforce it before the federal tax lien arose. It is pointed out in this dissent that a suit to enforce the lien had actually been instituted before the federal tax had been assessed and the tax liens recorded. The dissenting justice also pointed out that the Court's action was inconsistent with *U. S. v. City of New Britain,* where the Court held that the rule of "first in time, first in right" applies, when a lien is perfected under state law in the sense that nothing more can be done to make the lien choate; that is, when the identity of the lienor, the property subject to the lien, and the amount of the lien are definitely established. The dissenting judges jointed out that the implication of the present ruling of the Court is that a lien that is specific and choate can never prevail against a subsequent federal tax lien short of actual reduction of the lien to judgment.

O. K. Tennessee tax on sale of transmitted gas; it is a local business. A Tennessee corporation operating entirely within the state, engaged in the buying of natural gas from an interstate pipeline company a portion of which it resold to a large industrial user, is subject to tax upon its gross receipts, the Tennessee Supreme Court ruled in *Tennessee Natural Gas Lines, Inc. v. Atkins,* decided February 3. Taxpayer had contended that it transmitted rather than distributed natural gas in the statutory sense and that the sales were part of interstate commerce. The court ruled that the interstate transmission of natural gas ended when it was purchased in Tennessee by the taxpayer for resale. It concluded that the business of supplying local consumers is a local business even though the gas is brought from another state and drawn for distribution directly from interstate mains.

Certiorari requested: State of Texas v. RFC. The United States Court of Appeals for the Fifth Circuit ruled that the state of Texas could not assess penalties and interest against the Reconstruction Finance Corporation for delinquent property taxes. The court noted that Congress had made the Corporation's property subject to state and local ad valorem taxes but did not mention penalties and interest. It ruled that Texas law distinguished between the tax and penalties and interest and that therefore the state could not impose the latter on the RFC.

The reports here on significant new state tax decisions are provided through the cooperation of the Federation of Tax Administrators. They are adapted from Tax Administrators News.

NEW DEVELOPMENTS IN

Payroll taxes

EDITED BY PETER G. DIRR

Can one state deny income-tax exemptions to non-residents when granted to residents?

THE DISTINCTION between residents and non-residents in the granting of state income tax exemptions and deductions has always been fraught with interesting circumstances.

The New York case of *Travis* v. *Yale and Towne Manufacturing Company,* decided by the United States Supreme Court on March 1, 1920 is one of the landmarks. In this case the Court held that the provision of the New York State Income Tax Law granting exemptions to residents but not to non-residents was unconstitutional. Immediately following this Court decision the legislature of the State of New York passed Chapter 191 of the Laws of 1920 amending Section 362 of the Tax Law so that it makes the exemptions applicable to residents and non-residents alike and in like amounts. Mr. Justice Pitney delivered the unanimous opinion of the Court in that case and stated in part as follows:

"Nor can the discrimination be upheld, as is attempted to be done, upon the theory that non-residents have untaxed income derived from sources in their home States or elsewhere outside of the State of New York, corresponding to the amount upon which residents of that State are exempt from taxation under this act. The discrimination is not conditioned upon the existence of such untaxed income; and it would be rash to assume that non-residents taxable in New York under this law, as a class, are receiving additional income from outside sources equivalent to the amount of the exemptions that are accorded to citizens of New York and denied to them.

"In the brief submitted by the Attorney General of New York in behalf of appellant, it is said that the framers of the act, in embodying in it the provision for unequal treatment of the residents of other States with respect to the exemptions, looked forward to the speedy adoption of an income tax by the adjoining States; in which event, injustice to their citizens on the part of New York could be avoided by providing similar exemptions similarly conditioned. This, however, is wholly speculative; New York has no authority to legislate for the adjoining States; and we must pass upon its statute with respect to its effect and operation in the existing situation."

Many new laws make question hot

During the past year numerous states have enacted withholding taxes applicable to both residents and non-residents. Among them have been Alabama, Arizona, Colorado, Kentucky and Montana. While these statutes do permit exemptions to residents and non-residents alike they do not permit such exemptions in like amounts but rather reduce the exemptions of the non-residents in the proportion that their income reported to Colorado bears to their total income. Whether these laws conform to the dictum in the *Yale and Towne* case poses an interesting question. We are not aware of any pending litigation testing their validity. We would like to hear from our readers on this score.

Deduction for non-business expense

Just as exemptions are a problem in the taxation of non-residents so are deductions for non-business expenses, such as taxes, interest, etc. The most recent case on this point was rendered by the New York State Supreme Court, Third Department, on November 3, 1955, in the matter of *Goodwin v. State Tax Commission,* wherein the court held that there was no discrimination against a non-resident when the State did not permit to such non-resident the same non-business expenditures as are afforded to residents. It should be noted that the standard deduction is permitted to both residents and non-residents alike, apparently on the theory that being a flat sum it is relatively equivalent to exemptions within the meaning of the *Travis* case. Is it consistent to afford similar deductions to residents and non-residents who do not itemize expenses but to deny such deductions to residents and non-residents who choose to itemize them?

Again, this poses a very interesting question. In rendering its decision in this case the court said in part:

"If these expenditures are to be allowed as deductions at all, they should be allowed by the State of taxpayer's residence. Thus, in this case, if there were an income tax law in New Jersey, it might well be expected that New Jersey would allow deductions for residence taxes, mortgage interest and similar expenditures made by its residents. It happens that New Jersey has no income tax law but this does not warrant the petitioner's shifting the allowance for these expenditures, which are intimately connected with the State of his residence, to New York State."

Is not this quotation inconsistent with that portion of the opinion in the *Yale and Towne* case which stated—"New York has no authority to legislate for the adjourning states"? ☆

Disaster provisions in unemployment laws disapproved by Secretary of Labor

MANY EMPLOYERS have been waiting to learn the position of the Secretary of Labor on the so-called disaster amendments enacted in the Connecticut and Pennsylvania Unemployment Insurance Laws last year. A recent issue of *The Advisor,* published by the Unemployment Benefit Advisors, Inc. of Washington, D. C., notes that these amendments have now been found to be at variance with federal standards and have therefore been disapproved by the Secretary. We quote:

"The Secretary of Labor has found that recent amendments to the Connecticut and Pennsylvania unemployment compensation laws providing for the non-charging of benefits and the waiving of the waiting period in disaster

situations are at variance with the additional-credit standards (experience rating) in the Federal Unemployment Tax Act. Since the effectiveness of these amendments was made contingent on the Secretary's approval, no conformity issue is raised.

"Both the Connecticut and Pennsylvania amendments were the outgrowth of the hurricane and flood catastrophe of last August and September. It was reasoned that the waiting period was not in point where flood damage had occasioned widespread unemployment and there was absolutely no possibility of finding re-employment within the waiting period. Also the Legislatures reasoned that it was hardly equitable to charge an employer's experience with unemployment that was due to a catastrophe—an 'act of God.'

"The Connecticut provision was fatally defective in that it did not restrict non-charging of benefits to unemployment that was directly attributable to a catastrophe. It provided a statewide moratorium on *all* benefit charges—regardless of the reason for the unemployment—from August 21 to Oct. 29.

"Though a good argument can be made that an employer's experience with unemployment should not reflect unemployment due to catastrophe, certainly there is no ground whatsoever for a contention that unemployment having no relation to catastrophe should not be taken into account in measuring an employer's experience.

"The Pennsylvania amendment provided for non-charging only in those instances where unemployment was directly attributable to catastrophe or disaster. As before stated, a very good case can be made for the allowance of such treatment under the federal experience rating provisions. However, the two amendments were given like treatment—disapproved." ☆

Care required to prevent vacation pay and unemployment benefits being paid together

EMPLOYERS in New York State find themselves confronted with a difficult problem as the active vacation season begins. Through a series of liberalizing interpretations in the courts the view has developed that vacation pay will be considered as a bonus for past services and, therefore, not disqualifying in practically all instances where the vacation period is preceded or followed by a layoff for a day or more.

Those firms that have adopted the practice of closing down a plant for a two-week period and giving vacation pay during such time will now find their ingenuity taxed to make certain that the actual period of shutdown is exactly two weeks and no longer. Otherwise, they will find their employees drawing unemployment benefits during vacation periods, which could lead to serious drains on the unemployment insurance reserves.

The policy of the Division of Employment in connection with vacation pay was set out in a release of the Interpretation Section of the Field Operations Bureau which contains some 22 pages of explanatory material. The principles contained in such release are digested in a policy statement issued by the Division of Employment which reads as follows (note that while this policy is ascribed in part to the recommendations of the State Advisory Council "which represents management, labor and the general public" the management members of the Council did not concur in the recommendations):

"Policy on Unemployment Insurance Payments During Vacation Periods.

"The following general principles underlie the policy of the Division of Employment, State Department of Labor, in acting on benefit claims filed by workers granted vacation or affected by plant shutdowns for vacation purposes. The policy is based on law, on decisions of the Appellate Division of the State Supreme Court, and on policy recommendations of the State Advisory Council on Employment and Unemployment Insurance which represents management, labor and the general public.

"Under any circumstance, to be eligible for benefits, a claimant must be ready, willing and able to work and making appropriate effort to find work.

"1. A worker who takes a vacation (paid or unpaid) while his firm continues to operate is either still employed or is not available for work, and so is not entitled to benefits.

"2. If employees through their union as bargaining agent have agreed to a plant shutdown for vacation purposes and the actual shutdown is no longer than the vacation period, no worker in the bargaining unit represented by the union is eligible for benefits, whether he belongs to the union or not; whether he receives vacation pay or not. All are considered to have withdrawn from the labor market for the vacation period.

"3. If a plant closes for a vacation period *without union consent* and the plant closing does not exceed the vacation period, affected workers who do not receive paid vacation are unemployed and may qualify for benefits; workers who receive paid vacation *in part* are partly unemployed and can receive benefits for the unpaid part of the vacation period. Workers receiving full paid vacations are employed and are not eligible for benefits. These are payments which are provided for specific time off.

"In contrast, certain kinds of so-called 'vacation pay' provided for in management-labor contracts, or as a matter of employer policy, are actually bonuses for past services to which the worker is entitled whether he is granted vacation time off or not; whether he is still working for the employer or not. Such payments are not considered vacation pay, and if there is a plant shutdown for vacation, affected workers are unemployed and may be entitled to benefits.

"4. If there is a layoff which exceeds the vacation period for a day or more, affected workers are considered unemployed for lack of work and receipt of vacation pay will not make a claimant ineligible for benefits for any portion of the layoff period.

"Exception: If there is a tapering off in the employer's operations in the week before or a gradual resumption in the week after the vacation period which is *due solely to the vacation shutdown,* (e.g., banking of furnaces, sequence of operations, etc.) this is not considered a shutdown for lack of work. If a worker does work on one or more days in each of such weeks and receives the work which the employer has available, he is ineligible for benefits for those days during the vacation period for which he receives vacation pay." ☆

Massachusetts would waive charges in disaster

THE Massachusetts legislature recently adopted several resolutions memorializ-

ing Congress to enact legislation necessary to authorize state unemployment insurance agencies to waive charges against employers' accounts where such charges would adversely affect the employer's experience rating, if the unemployment is caused by curtailment of business resulting from hurricanes, floods, or other acts of God. ☆

Four states change unemployment laws

THE FOLLOWING changes are announced in laws governing unemployment compensation:

The New York State Unemployment Insurance Law was recently amended to provide for the waiver of the waiting period requirement in cases of unemployment resulting directly from a major disaster, with respect to which the Governor has declared the existence of a state of emergency.

The law was also amended to restrict the imposition of a subsidiary contribution to those employers who have been liable for contributions during at least the last 5 completed calendar quarters immediately preceding the computation date. This amendment is quite timely, since a 0.3% subsidiary contribution appears to be forthcoming in New York State.

Recent amendments to the Rhode Island Employment Security Law provide for the suspension of the required one week waiting period for claimants whose unemployment is directly due to a disaster. Also provision has been made for the imposition of a $10 penalty for failure to timely file reports or for failure to timely pay contributions.

Recent amendments to the Mississippi Employment Security Law increased the maximum duration of benefits, effective July 1, 1956, from 16 to 20 times an individual's weekly benefit amount. This means the maximum dollar benefits an individual will be able to receive in his benefit year have been increased from $480 to $600.

Effective on and after January 1, 1956, employers having individuals in their employ in at least six of eight calendar quarters ending on the June 30th computation date will be eligible for reduced rates. Formerly an employer had to have individuals in his employ in at least 10 of the 12 quarters ending on June 30.

Effective August 1, 1956 the maximum weekly benefit rate in Kentucky will be increased from $28 to $32, with maximum total benefits going from $728 to $832. In order to qualify for the $8 weekly minimum benefit a claimant will need $450 in base period wages. This was increased from $300.

Also effective August 1, the unemployment law was changed so that in addition to the regular conditions for qualification for benefits, a claimant must actively seek work while unemployed. ☆

NEW DECISIONS

TV writer is an employee of the network. An individual performs services for a television network as a writer and idea man. The nature of the services is such as to make close supervision impracticable, but the individual is required to perform the services personally, he is at all times subject to call by the network, he is required to confer with persons in regard to the work at places designated by the network, and his services are completely exclusive to the network. The Internal Revenue Service considers him an employee. *Rev. Rul.* 56-130.

New employment security law changes in Georgia

EXTENSIVE CHANGES have been made in the Georgia Employment Security Law. The most important changes are:

1. Amounts paid by an employer into a fund provided to supplement his laid-off workers' State Unemployment Benefits will not be taxable to the employer for State Unemployment Insurance purposes.

2. Claimants must earn at least 8 times the weekly benefit amount of any new benefit year claim after the expiration of the old benefit year, in order to again qualify for benefits.

3. For benefit years beginning April 1, 1956, the weekly benefits payable will range from $7 to $30 (formerly $5 to $26), with maximum benefits ranging from $140 to $600. Under certain circumstances, where the claimant has high base period wages, benefits will be extended for two weeks.

4. In addition to changing the individual employer's reserve requirements for securing reduced contribution rates, the over-all fund requirement for the allowance of reduced rates was raised. ☆

EXCESS PROFITS TAXATION: RECENT DECISIONS

Pre-1913 stock dividend is part of invested capital. Taxpayer had a deficit in earnings and profits (not required to be included in its equity invested capital). Prior to 1913 it had paid a stock dividend which it wished to add to its invested capital (increasing that credit and also increasing the excluded deficit). The District Court followed the *Owensboro* case (209 F.2d 617, CA-6) and this court affirms. Pre-1913 stock dividends must be recognized as reducing accumulated earnings and increasing capital. It noted that the Tax Court has refused to accept the reversal in *Owensboro* and that appeals from the Tax Court are pending in other circuits. *Baker Land and Title Co.*, CA-7, 4/4/56.

Corporation having sold all assets doesn't have "unused" credit to carry back. Taxpayer, a subsidiary of Bethlehem Steel, sold all its assets to another subsidiary at the end of 1945. The proceeds stood to its credit in a bank. The corporation was not dissolved but was completely inactive until 1948. It claimed an unused excess-profits-credit carryback from 1946. This court affirms the Tax Court in denying it; the corporation was a mere shell in 1946. The courts have denied a carryback to corporations which never resumed activity. The activity in 1948 cannot change the rule. *American Well and Prospecting Company*, CA-3, 3/22/56.

Can't use base period of bank acquired for assumption of its liabilities; no new capital used. The Service holds that the acquiring bank cannot use the base-period experience of the purchased bank. The assets of the purchased bank were acquired by the assumption by taxpayer of the deposit liabilities of the seller. No long-term bonds or stock were issued. Only when the purchaser increases its long-term liabilities or capital may it use the other's base-period experience. *Rev. Rul.* 56-163.

Postwar refund of World War II EPT a true refund. The United States issued bonds to the taxpayer during World War II as evidence of the 10% postwar refund of excess-profits tax. Eight years after the redemption of these bonds, the government sued to recover part of the

funds paid as tax due on the ground that there had been an erroneous calculation of the taxpayer's liability. The court holds that the bonds were a refund within the meaning of 1954 Code Sections 7405 and 6532 (b) and not a mere reduction in tax liability, therefore suit to recover them must be brought within two years after making the refund. *McKee Co.*, DC Ohio, 3/22/56.

Commissioner's valuation of invested capital not proven erroneous. [*Certiorari denied*] The district court held that taxpayer failed to prove that the Commissioner's valuation of common and preferred stock received in transactions connected with a mortgage foreclosure reorganization in 1909-1910 was erroneous. The Commissioner's valuation of property paid in was based on valuation of securities issued. The court also held that the taxpayer was not entitled to include in its equity invested capital, as an addition to its accumulated earnings, the difference between the face amount of general lien bonds of the old company in the reorganization and the fair market value of the preferred stock of the new company. It did not prove that it assumed the liability for those old bonds. CA-4 affirmed. *Western Md. Ry. Co., cert. den.* 4/23/56.

Interest on deficiency allowed only to date of granting of Section 722 relief. The Commissioner determined a deficiency in excess-profits taxes for the years 1940 and 1941 and was sustained in the Tax Court and in the Court of Appeals. However, prior to the date this decision became final, the Excess Profits Tax Council granted relief under Section 722, reducing the deficiency. The court holds that interest on the original deficiency is payable only to the date relief was granted under Section 722. [Section 3771(g) of the 1939 Code specifically provided that for years after 1941, interest is payable on refunds of 722 tax, thus offsetting the interest on the deficiency. *Ed.*] *Consolidated Electronics Industries Corp.*, Ct. Cls. 5/1/56.

Tax Court again holds that filing 722 petition with it doesn't open standard issues. In disallowing taxpayer's claim for Section 722 relief, the Commissioner raised a standard issue and assessed a tax deficiency. The Tax Court, following its decision in *Poe*, 25 TC No. 84, holds that the deficiency was barred by the statute of limitations. The Commissioner had argued that by filing the 722 petition with the Tax Court, taxpayer opened the entire tax liability for the year. *S. Frieder & Sons*, TCM 1956-93.

722 relief denied welder manufacturer; granted to bus maker and cannery. A manufacturer of electric portable welders was denied relief under Section 722(c) where there was no satisfactory proof that under peacetime conditions existing in the base period, and without the impetus of war-induced ship building activities, it would have been able to develop a profitable welding business within the two-year pushback period. *Nelson Specialty Corp.*, 26 TC No. 23.

A bus manufacturer which changed over during its base period from wood bus bodies to all-metal buses, and which experienced a long strike, was granted 722 relief under the pushback rule. *Fitzjohn Coach Co.*, 26 TC No. 24.

Similarly a vegetable and fruit cannery was also granted 722 relief where new management took control of the cannery in its base period and materially changed operating policies. *Flotill Products, Inc.*, 26 TC No. 25.

Tax Court may consider "standard issues" in Section 722 cases. The Tax Court has consistently held that it has no jurisdiction, in a Section 722 proceeding, to consider issues unrelated to the question of abnormality relief. The Court of Appeals reverses, pointing out that the Tax Court position is in conflict with that of eight Courts of Appeal. *Seminole*, CA-5, 5/8/56.

Section 722(b) relief denied to wholesaler of fruits and vegetables. Taxpayer, a wholesaler of fruits and vegetables, contended that its actual average base-period net income was an inadequate standard of normal earnings for excess-profits-tax purposes. The court concludes that taxpayer failed to show that business was depressed during the base period by circumstances claimed, namely, the competition of the so-called itinerant truckers and the free distributions of surplus commodities by the government, and denies relief under Section 722. *Oswald Co., Inc.*, 25 TC No. 116.

Unused excess-profits-credit carryback is applicable even though detrimental to the taxpayer. In 1944, the 80% total tax limitation of the Excess Profits Tax Act of 1940 was applicable to the taxpayer. In 1946 the taxpayer had a net loss, and its entire excess-profits-tax credit was a carryback to 1944. Because of the 1944 limitation, however, the total tax for that year was not reduced as a result of the carryback, but some $400,000 of taxes was transferred from excess-profits tax to income tax. This resulted in reducing the 10% postwar credit by about $40,000, with a consequent increase in the net tax liability. The taxpayer conceded that a literal application of the law resulted in this conclusion, but argued that the carryback was a relief provision and should be construed liberally in favor of the taxpayer. The court holds that, although Congress might have made an exception if it had been aware of this particular situation, it did not do so, and the language of the law makes the carryback mandatory. *Dravo Corporation*, Ct. Cls., 1/31/56.

Contested income taxes reduce EPT credit in taxable year, not settlement year. [*Certiorari denied.*] Although deficiencies in 1943 income and EPT were contested, they nevertheless reduced taxpayer's accumulated earnings and profits at the beginning of 1944 for invested capital credit purposes. Otherwise, by simply contesting liability for income and EPT, a taxpayer could postpone their accrual until after the year in which they arose, and its accumulated earnings and profits for the years prior to settlement would be overstated. *Pacific Affiliate Inc.*, CA-9, 7/20/55, *cert. den.* 2/27/56.

EPT deficiencies disallowed; Tax Court properly refused to open income tax. In the Tax Court, taxpayer contested various tax deficiencies for the years 1943 to 1948. It did not ask redetermination of the income-tax deficiency for 1944. The Tax Court made no determination on this item, but held that the 1944 excess-profits-tax deficiency claimed by the Commissioner was invalid. The Commissioner, under the Tax Court rules, could have moved for a re-hearing within 30 days to ask for an offsetting increase in 1944 income tax due to the EPT disallowance. The Tax Court denied various motions of the Commissioner and accepted taxpayer's computation of tax which left the 1944 income tax unchanged. This court affirms. The Commissioner did not avail himself of the opportunity to seek a rehearing within the proper time period, and on appeal offered no adequate

proof that the original income-tax deficiency was incorrect. One dissent on the ground that the facts as to the taxable income are clear. The Tax Court should have applied the statutory formula for computing these interrelated taxes under which a decrease in excess-profits tax automatically increases income tax. *Meldrum & Fewsmith, Inc.*, CA-6, 2/10/56.

Profits on retirement of own bonds not includible in excess-profits income. [*Acquiescence.*]Taxpayer contended that profits it realized in 1944-45 on retirement of its own bonds by purchase were not includible in excess-profits-tax income. The Tax Court sustained him holding they were excludible under the Excess Profits Act. *Ambassador Hotel*, 23 TC 163, *acq.* IRB 1956-11.

Entire interest deductible in years no excess profits credits computed or allowed. [*Acquiescence.*] In computing the unused excess-profits-credit carryover to 1943 from 1940, loss taxpayer had used the entire interest deduction and Commissioner contended that only one-half of the interest charges in the year 1940 should be used. The Tax Court held that no adjustment of interest deduction was necessary. The entire interest was deductible, as no excess-profits credit was computed or allowed for 1940. *Ambassador Hotel*, 23 TC 163, *acq.* IRB 1956-11.

Change of investment company to operating company no bar to use of its high historical invested capital credit. Officials of Atlas Corp. in order to simplify its corporate structure and to realize a tax loss decided to sell the stock of taxpayer, an investment company, after first divesting it of certain desired securities. Floyd B. Odlum, president of Atlas, agreed to purchase the stock at book value only because no other purchaser could be found. Soon after such acquisition Odlum contributed his stock in a wholly owned rubber company, VRC, to the taxpayer to change taxpayer into an operating company, and to give VRC the benefit of taxpayer's cash and liquid assets. The court found the series of transactions were not undertaken for the sole purpose of giving VRC an excess-profits-tax advantage by making available to it taxpayer's high historical invested capital credit; and it upheld taxpayer's right to use such credit in computing its excess profits tax liability for 1941. *Great American Industries, Inc.*, 25 TC No. 133..

722 relief granted for change in product. Taxpayer was permitted to reconstruct its base period to give effect to a change in product (lathes), a change in dealer system, and to reflect a lower interest cost because of a change in capital. *Bardens & Olivier, Inc.*, 25 TC No. 63.

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HELP WANTED

Tax Accountant—National Public Accounting Firm has an opening in its New York office for a man under age 35. In addition to being personable he must have a sound knowledge of accounting and federal income taxes. Actual tax experience with the Internal Revenue Service, a corporation, or a public accounting firm will be helpful but not necessary. The man selected must not only be able to prepare and review tax returns, but also to research problems. Starting salary will be commensurate with experience and further promotions will occur just as rapidly as the man proves his ability Box 70.

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Woman tax attorney, 10 years with CPAs, seeks position in New York City. Box 71.

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